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University of Kansas, School of Business

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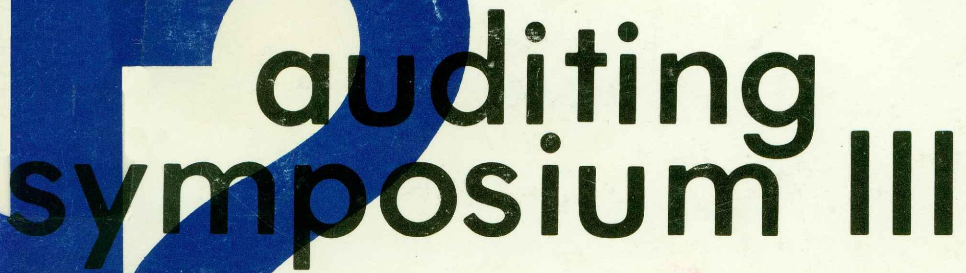

auditing symposium III

Proceedings of the
1976 Touche Ross
University of Kansas
Symposium on
Auditing Problems

HOWARD STETTLER, EDITOR

Auditing Symposium III

Proceedings of the 1976
Touche Ross/University of Kansas Symposium on
Auditing Problems

Edited by
Howard F. Stettler

May 13 and 14, 1976
School of Business
University of Kansas
Lawrence, Kansas 66045

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Preface

The 1976 Touche Ross/University of Kansas Symposium on Auditing Problems constitutes the third offering in this biennial series of symposia designed to bring practitioners and educators involved in the field of auditing together to study matters of mutual interest and concern. On the assumption that the series is now firmly established, I have chosen to identify this volume of the proceedings both simply and explicitly as *Auditing Symposium III.*

As before, planning efforts were directed toward a balance between practitioners and educators in the preparation of papers, with the discussant for each paper from the opposite group, and with a similar balance in the invited participants. All papers, except for the traditional evening address on a more general topic, were distributed in advance, making it possible for the preparer to limit comments to summary remarks or observations about the paper and leaving more than an hour for the discussant's remarks and the ensuing open discussion. Although no attempt has been made to summarize the informal discussions, both the preparers and the designated discussants were afforded the opportunity to modify their papers and remarks to reflect matters that arose during the general discussion.

The inclusion of the paper "An Auditing Perspective of the Historical Development of Internal Control" extends my endeavor to assemble a series of papers that will eventually provide a comprehensive dissertation on the development and heritage of the auditing segment of the accounting discipline. The additional papers reflect a unifying theme only in that they were chosen with the expectation that the subject would be of current interest to the participants and to the readers of this volume of collected papers.

As has been true for each of these symposia, I take full responsibility for the selection of topics for both the invited and the submitted papers, but the views expressed in the papers are those of the preparers, and, of course, not necessarily those of the organizations with which they are affiliated. Those interested in these auditing symposia are once again invited to submit papers, with a cut-off date of September 1, 1977 for papers to be considered for the 1978 symposium.

Auditing Symposium III for 1976 and the printing of these Proceedings would not have been possible without the financial support of Touche Ross Foundation, and in that connection I also wish to acknowledge the gracious personal assistance of Jerry Jackson, managing partner of the Kansas City office of Touche Ross & Co.

HOWARD F. STETTLER

October, 1976
University of Kansas
Lawrence

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1

An Auditing Perspective of the Historical Development of Internal Control

Willie Hackett and Sybil C. Mobley
Florida Agricultural and Mechanical University

It is conceivable that internal control preceded auditing and other elements of the accounting profession. Internal Control emerged as a common-sense, natural product of the profit motive. As soon as the first entrepreneurs contrived a method for making a profit, they contrived ways of controlling and protecting that profit. As soon as it was determined that profits could be expanded by the employment of others, it was recognized that complete trust was not the most profitable policy and that some form of control should be established.

This paper recapitulates the findings of accounting historians who have studied the historical development of internal control; however, it should be recognized that the history of internal control is still being researched and documented.

Early Beginnings

Kenneth Most[1] has stated that there is concrete evidence that internal control existed in the Mesopotamian civilization as early as 3600 B.C. Most points out that the Sumerians recorded commercial transactions on stone dating back to 3600 B.C. and 400 years later on clay. It was customary for summaries to be prepared by scribes other than those who had provided the original lists of payments. Further, the documents of the period reveal tiny marks, dots, ticks, and circles at the side of the figures, indicating that checking had been performed. Williard Stone noted[2] that in ancient Egypt, in the Pharaoh's central finance department, the "house of silver of the treasury," internal control and auditing were in use. Scribes prepared records of receipts and disbursements of silver, corn and other commodities. One recorded on papyrus the amount brought to the warehouse and another checked the emptying of the containers on the roof as it was poured into the storage building. An audit was performed by a third scribe who compared these two records. An official order was required for withdrawals and the scribe in charge of the storehouse recorded the disbursements and retained the order. His records of receipts, disbursements and inventory balances were periodically audited by another scribe or his superior.

Stone gives an account of internal control in the Persian civilization of 549 to 330 B.C. He reports that Darius (521-486 B.C.) used government scribes, called the "King's eyes and ears," to perform an important function in the control of his extensive empire. For convenience of administration the empire was sectioned into satrapies each with a "satrap" as the civil administrator and tax collector.

Government of these provincial units was divided; the troops were under a general, and a royal secretary performed the duties of an internal auditor, reporting to the King's minister on the activities of the satrap and the general. The royal secretary accounted for taxes collected and remitted to the King.

The "King's eyes and ears," accompanied by a military escort, made surprise audits of the affairs of the provinces. These traveling government auditors were empowered to examine all records, question the satrap, the royal secretary, or any other officials and to take immediate corrective action if it was believed to be necessary.

Extending his historical account, Stone points out that like the Persian Empire before it, the Roman Empire made effective use of accounting and auditing to control the generals of conquered territories. The counterpart of the "King's eyes and ears" were the "quaestors," who came into being about 200 B.C. They were financial officers responsible to Rome, who had custody of the treasury, supervised the scribes in their duties of recording treasury receipts and disbursements, and examined the accounts of the governors of subjugated countries. The quaestors were required to report periodically to Rome and to have their records heard by an examiner. The word "auditor" came into use through this practice.

The Roman Empire made use of a complete system of checks and counterchecks. They separated the duties of collecting revenue, authorizing expenditures, maintaining custody of cash, and recording financial transactions. Expenditures were required to be supported by documents disclosing the identity and title of the creditor and attesting the completion of the work or receipt of the goods called for by the order. Magistrates authorized payment on the basis of these documents and after disbursement, treasury scribes recorded all transactions. Quaestors supervised and audited all government financial transactions. Tax examiners also were used in Rome and played a prominent role in the collection of government revenues.

The Holy Roman Empire under the leadership of Charlemagne followed the example of the Persian and Roman Empires in using government auditors to control the affairs of state. Missi dominici, "emissaries of the master," were sent to review the affairs of the various administrators. The emissaries carried instructions from Charlemagne to local officials, made audits of their records, reviewed their actions, and reported the results to the King. Unfortunately for the Empire, after the death of Charlemagne (825 A.D.) no strong organizer appeared to take his place and within one generation the missi dominici were disbanded, control of the local rulers was lost, and the Empire disintegrated.

In the middle ages, accounting, along with the other arts, suffered a decline because of the general disorganized condition of government and the economy throughout Europe. Gradually, however, accounting was reestablished.

R. Gene Brown[3] has pointed out that prior to 1500, accounting was concerned primarily with governmental and family units. The practice of internal control was evidenced by the use of two scribes who kept independent records of the same transactions designed to prevent defalcations within the treasuries of the ancient rulers. A secondary objective was assurance of accuracy in reporting. Inventories were periodically taken to prove accountability and to establish the accuracy of the accounting records.

During the period 1500-1850, which L. Fitzpatrick, B. F. Foster and William

Jackson[4] have identified as the period in which a standardized system of double-entry accounting became regarded as necessary, the recognition of the importance of internal control also gained acceptance.

1850 to 1940

From 1850 to 1905, the rise of the large corporation to permit exploitation of the technology produced by the Industrial Revolution was seen. The operation of the principal enterprises passed from the hands of the owners to those of the managers. To protect the interest of the absentee owners a new professional class of auditors emerged, the independent auditors.

R. Gene Brown[5] points out that although internal control was recognized as existing in standardized systems of accounting, little interest was shown in any systems of controls for assets other than that for cash, and not much attention was paid to internal control by the independent auditors. The built-in control inherent in double entry accounting was often the only cross-check recognized as significant for all acounts. Because of this, the audits during the period 1850 to 1905 usually involved rather complete reviews of transactions and the preparation of corrected accounts and financial statements. This was inefficient, expensive, and did not satisfactorily provide for strengthening of weak areas in subsequent periods. The need for changes in the accounting system to improve the accuracy of reported amounts and reduce the possibilities for fraudulent acts was obvious. As the accounting system and the organizational structure were strengthened, and as the volume of transactions continued to grow, the technique of sampling became accepted practice for auditors.

Brown points out that prior to 1905, a natural basis for limiting the amount of testing to be done in auditing would have been the improvements in accounting systems, and consequently in internal controls, which existed in the larger corporations. However, it was not until the period 1905 to 1933 that auditors fully realized the importance of internal controls and the relation of strengths and weaknesses therein to their testing programs.

During this period the literature began to reflect more fully the importance of internal control and its relation to the extent of audit testing to be done. Montgomery and other authors including E. V. Spicer, E. C. Pegler, F. R. Carnegie Steele and De Witt Carl Eggleston referred to the system of internal control as of primary concern to the independent auditor in accepting the accounting data as being reliable, subject to the testing process. Brown notes that the literature was far ahead of actual practice. Practitioners continued to expand use of the technique of testing, but the decision as to the extent of testing was seldom directly tied to an appraisal of internal controls.

In 1926, the New York Stock Exchange's special Committee on Stock List campaigned for improvements in auditing. In 1929, the then American Institute of Accountants (now AICPA) undertook to revise the 1917 *Federal Reserve Bulletin,* "Approved Methods for the Preparation of Balance Sheet Statements." Of special significance in this revision, which was titled *Verification of Financial Statements,* was the requirement that the extent of testing used in an audit be based on an evaluation of the effectiveness of the system of internal control. In 1930, the Institute established a Committee on Cooperation with Stock Exchanges

to formulate methods that would avoid a future repetition of the misleading financial reporting practices and poor quality of auditing that were a factor in the 1929 stock market crash.

A subsequent revision of the 1929 AICPA pamphlet by a special Institute Committee, was issued under the title, *Examination of Financial Statements by Independent Public Accountants,* in 1936. It included important sections on the philosophy of financial statements, their significance and limitations, and broad responsibilities of the auditor and the propriety of reliance on effective systems of internal control.

However, the great impetus for the development and elaboration of the system of internal control came from those practicing as independent auditors, spurred by the fear of legal liability. Unlike the jurisdictions under the British Legal System, the cases decided in the United States held that although management has primary responsibility for the system of internal control, the auditor has a duty to review the client's system. This duty was firmly established in the investigation of the Mc Kesson and Robbins case by the SEC. The Summary of Findings and Conclusions (Accounting Series Release No. 19) stated in part:

> We are convinced by the record that the review of the system of internal checks and controls at the Bridgeport offices of Mc Kesson and Robbins was carried out in an unsatisfactory manner. The testimony of the experts leads us to the further conclusion that this vital and basic problem of all audits for the purpose of certificating financial statements has been treated in entirely too casual a manner by many accountants. Since in examination of financial statements of corporations whose securities are publicly owned, the procedures of testing and sampling are employed in most cases, it appears to us that the necessity for a comprehensive knowledge of the client's system of internal check and control cannot be overemphasized.

The Mc Kesson and Robbins case prompted great disagreement as to the auditor's responsibility for the detection of fraud and the significance of fraud detection as an audit objective. During this period of disagreement, the use of testing as an audit procedure became generally universal and internal control gained wide acceptance as a basis for determining the extent of examination required.

1940 to the Present

The importance of internal control has continued to grow. Some of the contributing factors have been:

1. The increasing impossibility of a detail audit due to the high volume of transactions
2. The need to reduce the cost of the external audit
3. The increasing complexity and size of business required more sophisticated control techniques to
   a. provide timely feedback on errors and fraud
   b. provide special analyses
   c. insure internal administrative controls
4. The needs imposed by the multi-plant and branch nature of operations to

a. insure uniformity of accounting procedures and consistency of applications
b. verify interplant transactions and profit center reports

5. The external audit procedure has shifted from a review of past operations to a review of the system of internal control. As a result, the reliance on the system of internal control continues to increase.

Conceptual Development of Modern Internal Control

A study of auditing textbooks over the past half century reveals that the conceptual development of internal control has kept pace with developments in the concept and practice of management and in the complexity of the firm. Excerpts from several editions of *Montgomery's Auditing* are presented in an effort to trace that development.

The 2nd Edition of *Montgomery's Auditing* (1912) made no mention of the terms "internal control" or "internal auditing." However, the related term, internal check, was discussed. The emphasis was that of reliance on internal check by external auditors. It stated that "Such a system consists in the accounting records, methods and details generally of an establishment being laid out in such a way that no part of the accounts will be under the absolute and independent control of any one person; that, on the contrary, the work of one employee will be complementary to that of another; and that a continuous audit will be made of the details of the business." This description identifies the scope of internal check as including both internal accounting controls and internal auditing. Six pages were devoted to a discussion of the system of internal check.

Twenty-two years later, the 5th Edition of *Montgomery's Auditing* (1934) devoted seven pages to the discussion of the system of internal check and the internal auditing department. The term "internal control" was not yet in use. The definition of the system of internal check was substantially the same, encompassing both internal accounting controls and internal auditing. Two pages were devoted to internal auditing under a separate subheading. The verification of detailed records and the safeguarding of assets was considered the function of the internal auditing department. The author's interest in this area continued to be the need to avoid a detailed audit. The independence of the audit department was discussed. However, concern was only to the extent independence assures a system of internal check on which the external auditor can rely.

Montgomery's 6th Edition (1940) introduced the word "control" as an extension of the term internal check and devoted six pages to the discussion of the system of internal check and control and to the internal audit department. In the 6th edition, internal check was defined as the "arrangement of bookkeeping methods and procedures so that no part is under the absolute control of one person; and the work of each person is complementary to that of another." This is a narrower definition than that given in the 5th edition as it excludes internal auditing. Again, internal auditing is discussed under a separate subheading. In discussing independence, the 6th edition recognized that, although theoretically internal auditing should be independent of the accounting department, in practice the internal auditor generally reported to the chief accounting officer. The author's concern was again with the use of the internal check and control system as a basis for limiting the scope of the audit.

Internal Control was the topic of an eight-page chapter in the 7th Edition of *Montgomery's Auditing* (1949). A Statement of Auditing Standards had been issued by the Committee on Auditing Procedure of the American Institute of Accountants in 1947 which established the evaluation of the client's system of internal control as one of the standards of field work. The standard stated:

> There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

In addition, the following formal definition of internal control was published in 1949:

> Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies . . . a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments.[6]

These events in part probably account for Montgomery's 7th edition treatment which reflected a broadening of the scope and function of internal control. The discussion covered such topics as budgetary and cost accounting systems, and the enhanced status of the internal auditor including the dual reporting responsibility to the controller and to the board of directors. In commenting on the growth of internal auditing, the 7th edition reported that "As business expanded, the need was seen for centrally controlled policing of the accounting function of many organizations composed of numbers of dispersed units. This need is filled by the internal auditor's department. . . . The internal auditor also acts as the direct representative of the controller to investigate and report whether prescribed accounting policies, procedures, methods, and routines are followed."

The internal auditor is presented as "an important element of internal control. . . . Internal control is greatly strengthened by a well-operated internal auditing group."

The 7th edition substitutes the term "internal control" for the term "internal check." Absolutely no reference is made to internal check. The 7th edition also introduced the standard questionnaire for the evaluation of internal control as a "practical and useful device for investigating and recording the auditor's inquiries into the system of internal control."[7]

In the 8th Edition of *Montgomery's Auditing* (1957), the treatment of internal control accounted for twelve pages. Based on the definition of the Auditing Procedure Committee of the American Institute of Certified Public Accountants, the concept of internal control was classified into three areas: internal administrative control, internal accounting control, and internal check. The authors cautioned that the committee's definition was "very broad" and questioned whether the independent auditor should be concerned with internal administrative control.

With the 8th edition, terminology becomes definitive in ways markedly different from earlier editions. The term "internal control," having first been introduced in the sixth edition (1940) as an extension of the already established term

"internal check," is now presented as the broader term. Internal accounting control and internal check are considered as components of internal control. As an auditing text, the interest in internal control continued to be its adequacy for reliance on by independent auditors. Internal administrative controls are considered to be beyond the responsibility of the independent auditor in an examination leading to an opinion on the financial statements.

The impact of the work of the internal auditor on the quality of the accounting data is recognized: "In weighing the effectiveness of internal control, he (the independent auditor) will give due consideration to the work of internal auditors. He will, of course, investigate procedures of the internal auditing group, just as he investigates other features of its control."[8] However, the principal thrust of the discussion on internal control was the concern of the independent auditor for all three areas of internal control and the similarities and differences in the roles and approaches of internal and independent auditors.

The chapter on internal control in the 9th Edition of *Montgomery's Auditing* (1975) is 25 pages long. The fact that the concept of internal control has changed is acknowledged. According to this edition, however, internal control still consists of internal administrative or operational control, internal accounting control and internal check.

In this edition, internal control is presented in a logical structure. Systemization, competence and integrity, and documentation are named as the three conditions of control. The forms in which *basic control operations* appear are stated as outlined below:

- Forms of Validation
  - Authorization
  - Comparison
  - Validity checking
- Forms of Completeness Checks
  - Numerical sequencing
  - Control totals
  - Holding files
  - Reminder files
- Forms of Reperformance
  - Double-checking
  - Pre-audit

Disciplinary controls are listed as segregation of duties, restricted access, supervisory controls, and internal audit (optional).

In this edition, as in the other editions, the concern is for determining the extent and nature of the audit by independent auditors. It is suggested that effective internal control may transform auditing from tests of underlying data to tests of controls.

The term "internal operational control" is introduced as synonymous with the term "internal administrative control." It is very likely that it will become the more widely used term. Whereas, in the 8th edition, the authors are explicit in stating that internal administrative control is not the responsibility of the independent auditor, they question the wisdom of this position in the 9th edition.

In support of their opinion that someday the independent auditor will be expected to evaluate operational controls, they state:

> There are many instances in which operational controls affect the reliability of accounting data in direct and indirect ways; . . . Since operational controls can have a profound effect on financial position and results of operations and can, on occasion, substitute for accounting controls, they are an appropriate subject of interest to an auditor. . . . If he *does* understand operational controls, however, he will be able to plan a more efficient and effective engagement by relying on the controls, where appropriate, and by recognizing the potential for problems if controls are weak.[9]

Internal audit, as a part of internal control, is deemphasized in this edition. One paragraph is devoted to internal audit as a disciplinary control. However, a more lengthy discussion is provided in a chapter entitled "Working with a Client."

Development of the Internal Audit Function

The internal auditing function, which had its beginning as an internal check procedure used to avoid the necessity of a detailed audit by external auditors, has exploded. Once defined as "the vertification of detailed records and the safeguarding of assets," it is now defined thus:

> Internal auditing is an independent appraisal activity within an organization for the review of operations as a service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls.[10]

This growth has been described by Brink, Cashin and Witt:

> The first internal auditing assignments usually originated to satisfy very basic and sharply defined operational needs. The earliest special concern of management was whether the assets of the organization were being protected, whether company procedures and policies were being complied with, and whether the financial records were reliable. . . . Over a period of time, however, this situation has changed a great deal. The operations of the various organizations were increasing steadily in volume and complexity. The managerial problems thus created have resulted in new pressures on higher level management. . . . At the same time, the internal auditors themselves were perceiving the existing opportunities and were more and more initiating new types of service. Thus, internal auditors took on a broader and more management-oriented character. Because the earlier internal auditing was very much accounting oriented, this upward trend was felt first in the accounting and financial control areas. Subsequently, however, it was extended to the non-financial areas.[11]

The establishment of the Institute of Internal Auditors (1941) and the publication of *Internal Auditing* by Victor Z. Brink (1941) must be viewed as significant events in the growth of internal auditing as a unique function practiced by a large group with its own professional organization, code of ethics and other pronouncements, and professional certification. Once viewed only as a part of the internal control system, but now constituting a system within itself, internal auditing promises to become "the tail that wags the dog."

Footnotes

1. Kenneth S. Most, "Accounting by the Ancients," *The Accountant,* May 1959, p. 563.

2. Williard E. Stone, "Antecedents of the Accounting Profession," *The Accounting Review,* April 1969, p. 286.

3. R. Gene Brown, "Changing Audit Objectives and Techniques," *The Accounting Review,* October 1962, p. 696.

4. As cited by Brown, *Ibid.*

5. *Ibid.,* pp. 698-9.

6. As quoted in American Institute of Certified Public Accountants, "Codification of Auditing Standards and Procedures," Statement on Auditing Standards No. 1, 1973, p. 15.

7. Robert H. Montgomery, Norman J. Lenhart, and Alvin R. Jennings, *Montgomery's Auditing,* Seventh Edition, The Ronald Press Company, 1949, p. 56.

8. Norman J. Lenhart and Philip L. Defliese, *Montgomery's Auditing,* Eighth Edition, The Ronald Press Co., 1957, pp. 53-4.

9. Philip L. Defliese, Kenneth P. Johnson, and Robert K. Macleod, *Montgomery's Auditing,* Ninth Edition, The Ronald Press Company, 1975, p. 61.

10. The Institute of Internal Auditors, "Statement of Responsibilities of the Internal Auditor," Orlando, Florida, 1957.

11. Victor Z. Brink, James A. Cashin, and Herbert Witt, *Modern Internal Auditing: An Operational Approach,* Third Edition, The Ronald Press Company, 1973, p. 5.

Discussant's Response to An Auditing Perspective of the Historical Development of Internal Control

Rodney J. Anderson
Clarkson, Gordon & Co.

By way of explanation relative to my remarks as discussant, please consider that it was only yesterday that this paper reached my hands.

The paper may be said to consist of three elements:

1. An overview of the historical development of auditing and internal control,
2. The development of North American thinking on internal control during the 20th century, and
3. Present thinking on internal control and internal auditing.

I will organize my comments with respect to each of these three elements and finally use the third as a jumping off point for a few other related thoughts about control.

Overview of Historical Development

The first eight pages, indeed half the paper, deal with an overview of the historical development of auditing and control. I found this interesting and readable. I think it gives a good summary of the early beginnings. Perhaps it could have gone a little more into the big jump from Charlemagne to the Industrial Revolution—a period where, I think, the roots of many of our present practices may be found. I will refer again to this presently. The authors state that control was the natural product of the profit motive. In the general sense of human acquisitiveness ("Let's protect what we've got."—and what we're getting), I agree. But in the narrower sense, profit motive suggests commercial transactions. In contrast, it was more commonly the wealth and the taxing power of the ruler or government which was being protected in those precursory days. As an oversimplification, we might say that control in auditing began with public funds (if one may use that euphemism for the ruler's hoard). And perhaps if the government take of the GNP continues at its present rate, we will soon come full circle. And future historians may look wistfully back at the 19th and 20th centuries as the age of private enterprise. However, that's not the subject for this conference.

In any case, whether the very beginnings were private-commercial or ruler-public is always a little difficult to tell from the literature. Certainly the examples of Egypt, Persia and Rome are all public funds examples. On the other hand, it

may simpy be that such archeological records survive more easily. The references to Sumerian transactions in 3600 B.C. may indeed be commercial. Similarly, I located an interested excerpt from one of the provisions of Hammurabi's code from Babylon of 2200 B.C. Article 105 read: "If an agent has forgotten and has not taken a sealed memorandum of the money he has given to the merchant, money that is not sealed for, he shall not put in his accounts." This would certainly seem to be commercial and would suggest the keeping of commercial accounts and rudimentary elements of internal control.

And yet, one can find conflicting quotations. Dr. Budge of the British Museum was quoted as saying in 1905: "There is no reason for thinking that they (the Babylonians and the Syrians) managed their money affairs as we do. There are many contract tablets known, and hundreds of records of commercial transactions, but I know of none which could be considered as accounts in the modern sense of the word."

Be commerce as it may, the control and audit of government funds was surely the predominant influence on early developments.

Mention is made of the division of duties among the Pharaoh's scribes—and certainly division of duties is still an important element of internal control. Likewise, mention is made of the Persian surprise audits. Similarly, one might add, the Greeks had a group of checking-clerks to check public officials' accounts.

The paper goes on to refer to the quaestors and the division of duties over the Roman funds—and the source of the word audit as a hearing. Indeed, the division of duties there saw legislative control over public revenues and expenses vested in the Senate, the power to order payments vested in the censors, the farming of tax collection rights to publicans by the censors in the presence of the quaestors, and the actual handling of receipts and payments by the quaestors. Certainly this was an elaborate system of control.

The account then touches on the Holy Roman Empire and Charlemagne—and again this involves control and audit of government funds.

Then comes the gap—a jump to 1850 and the Industrial Revolution. But it is during this gap that we see the main switch from control and audit of government alone, to control and audit of commerce—at least more as we know it today.

The authors merely refer to the period of 1500 to 1850 as a birth of double entry. I think this might have been explored further since double entry has surely become one of the most important, though rudimentary, elements of internal control. The first evidence of double entry seems to be in Genoa in 1340 and involved the stewards to the local authority (again government). From there it moved to Venice and became known as "method of Venice." Later it moved to Florence. Why this growth? Of course, it was due to the Italian maritime expansion. We all remember that it was during this period that the Italian merchant fleets spread all over the world—indeed, providing the source of the name "America." Ships coming from the East and from the New World were financed principally as joint ventures, and pre-eminent among these were the Venetian fleets. And so, in 1494 in Venice we have the first treatise on bookkeeping.

The treatise was by a mathematician, Luca Paciolo (the spelling of his name varies), whose book *Summa de Arithmetica, Geometria, Proportioni et Proportionalita* included a section of 36 chapters on bookkeeping entitled "De Computis

et Scripturis" (Of Reckonings and Writings). Paciolo recommended the method of Venice. Three different accounting books were suggested. The first was a "memorial" in which one converted all the transactions to a consistent coinage (showing that foreign exchange translation problems did not originate with the FASB). The second was a journal to enter the converted amounts. The third was a ledger for posting. Other writers added to the literature on accounting and control in Venice in the following years.

Reference to England might have been mentioned before arriving at 1850—if only because it leads to the birth of our modern profession. Some authorities maintain that the English royal revenue was audited from the reign of William the Conquerer. But generally the establishment of the English Exchequer is assigned to the reign of Henry I (in 1100). Three independent records were maintained and were checked to each other at the end of the year. Originally they were audited by justices or barons (or their clerks) and later by official auditors. In England during the feudal ages auditors would travel on circuit to the manors and estates to check the accounting for disbursements and revenues. Indeed, there was a tradition that the best ale in the house was opened on such occasions. Whether or not this contributed to clean opinions is no longer known, but the beverages were referred to as "audit ale."

Some writers have argued that the stable financial controls in Elizabethan England can be attributed, in part, to auditors appointed by the Crown.

And that leads us to the 17th and 18th centuries and the growth of common law corporations in place of one-time joint ventures. Some of the bad speculative practices of this period led to the South Sea Bubble in 1720. During this period, therefore, the practice of accountancy developed further in order to accommodate the investigation of bankruptcies and other disasters.

Finally, we arrive at 1850—or perhaps more specifically 1844 with the passage of the English Joint Stock Companies Act. This Act provided for the appointment of auditors, though they were not independent. It generally ignored internal control, despite the earlier urgings of Paciolo, and during this period auditing was basically done on a 100% basis and was largely fraud-oriented.

By the early 1900's, the paper points out, auditors were still doing 100% checking for clerical accuracy plus some examination of internal documentary evidence. Testing was not used and little, if any, external evidence was examined.

Comparative Development of Thought on Internal Control in England and North America in the 20th Century

The authors refer to the growth of the control concept from 1905 to 1933. I think it might be interesting to compare the trends in the United States, England, and Canada during his period. During the early 1900's, the statutory audits in Canada and the U.K. led to 100% checking. However, by 1930, the concept of testing had begun, though little attention was being paid to internal control. A slight amount of external evidence was being examined.

Meanwhile, in the United States, audits were being performed not for statutory purposes but for credit-granting purposes. This led to the idea of the balance sheet audit as opposed to the clerical checking of Canada and the U.K. Subsequently, the idea of the balance sheet audit spread to Canada. At the same time

there was a move toward fairness of presentation. In 1913 and 1917 we have the advent of income taxes in the United States and Canada with the result of further emphasis being given to earnings. Then came the stock market crash of 1929 and following that more emphasis being placed on presentation, earnings, and the income statement as opposed to the balance sheet. In the 1930's with the formation of the SEC, the United States became, for those of us in Canada, the dominant influence replacing the U.K.

In 1934 we have the beginning of the examination of external evidence in any quantity. In 1939, the McKesson & Robbins case provided further impetus to these developments (I thought the quote in the paper on control was interesting here as we usually think of this case as just being related to inventory observation). Then in 1941 generally accepted auditing standards were called for by the SEC and in 1948 promulgated by the AICPA. I'm afraid in Canada, we did not arrive at a statement of generally accepted auditing standards until the 1960's at the provincial level and not until 1975 at the Canadian Institute level.

I think it's interesting to note that with the gradual addition of external evidence to Canadian auditing practice (following English precedents) and with the gradual addition of checking of transactions to U.S. auditing (in order to justify reliance on control) the two audit streams in North America moved together. Meanwhile, the U.K. also shifted from fraud detection to assurance of fair presentation with due reliance being placed on control. All these trends are difficult to assess in retrospect, as what historical writers now say and what actually took place may often be two different things.

I thought it was an interesting idea to follow the changing views in the successive editions of *Montgomery's Auditing*. I don't have any particular comment on this part. A lot of the material involves questions of semantics. Finally, with the 9th edition of *Montgomery's Auditing* in 1975 we are up to "where we are now."

Present Thinking on Internal Control and Internal Auditing

The 9th Edition of *Montgomery's Auditing* presents a more elaborate analysis of the components of internal control and I think this is useful. It has become now not just an excuse for reducing tests but something that auditors have decided they really must study in a systematic manner. With the AICPA Statement on Auditing Procedures No. 54, we have the introduction of the concept of compliance tests and with that another dimension was added. I might use these ideas as a jumping off point to discuss a few comments on internal control classification.

Internal Control Classification

Several different methods of classifying controls exist, some of which are suggested in the quotation from *Montgomery's Auditing.* Among the possible methods are:

1. By attest or non-attest significance.
2. By objective of the controls.
3. By accounting controls versus administrative controls.

4. By preventive controls versus detective controls.
5. According to the general nature of the control technique.

With respect to the attest versus non-attest significance, I think it is important to emphasize that internal control is primarily a management tool and only secondarily of audit use. It follows, therefore, that some controls will be important for management but have no influence on the auditor's work and some controls will be as good as it is practical for management to make them but still not sufficient to permit significant reliance by the auditor.

With respect to classification of controls by objective one could talk about safeguarding of assets, reliability of accounting records, the timely preparation of reliable financial information, profitability and minimization of unnecessary costs, the avoidance of unintentional exposure to risk, the prevention of detection of errors and irregularities, the assurance that delegated responsibilities are being properly discharged, and the discharge of statutory responsibilities by the management group. Of course, some of these objectives overlap. In any case, this matter of classification is not particularly helpful in analyzing control techniques since the same technique can often serve several different objectives. For example, perpetual inventory records independent of the storekeeper may help to (a) safeguard inventory, (b) ensure accurate inventory records, (c) detect inventory shortages, and (d) prevent irregularities.

The split of accounting controls and administrative controls has been in professional literature for some time. Originally, accounting controls were said to be related to safeguarding assets and influencing the reliability of financial reporting while administrative controls were concerned with promoting operational efficiency and adherence to prescribed management policies. However, some administrative controls affect the reliability of financial reporting as well. I confess I do not find it a very useful distinction. I rather think that the auditor must look at any type of internal control which could have a bearing on his expression of opinion on the financial statements.

The distinction between preventive controls and protective controls can be a useful one. The idea was incorporated in a recent Canadian Institute publication "Computer Control Guidelines" though no doubt it has been discussed many other places as well. Preventive controls prevent errors or reduce the chance of error occurrence. Detective controls detect errors or increase the chance of their detection. Of course, usually one must have both types of controls. Preventive controls are perhaps what the 9th Edition of *Montgomery's Auditing* refers to as disciplinary controls. One distinction between the two types of controls is their auditability. The auditor can observe preventive controls relatively easily, though it may be hard to evaluate their effectiveness. The operation of detective controls. on the other hand, is very difficult to prove. That they are operating when an error is caught is clear. But whether they were really operating in between the catching of successive errors is less clear. One can only assume that if another error had occurred it would have been caught but one cannot really prove that the detective control was functioning in those cases.

Perhaps the most useful method of analyzing internal controls from the auditor's point of view is by the general nature of the control technique. There are many different ways in which such an analysis can be made. One way would be as follows.

Organization controls may be said to deal with honesty and competence (hiring, supervision, training), segregation of functions (custodial versus reporting versus operating functions) and the overall plan of organization together with the accounting/financial organizational plan. *Systems development controls* deal with the development, approval and revision of systems—and must be considerably more formal in the case of computer systems. *Authorization and reporting controls* deal with authorization, comparison, validity checking, budgets, responsibility reporting, etc. *Accounting systems controls* deal with initial recording (document design), general ledger and account organization and balancing routines. *Additional safeguarding controls* cover things such as restrictive access, protection of records, periodic count and comparison, insurance, etc. *Management supervisory controls* deal with the personal supervision by management, the monitoring of controls and the detecting of errors, and the internal audit program. And finally, *documentation controls* cover manuals of policies and procedures and, in the case of computer systems, more elaborate documentation of systems and programs.

The Wagging Tail

Of the foregoing seven different types of controls, one can see that internal audit is but a part—though admittedly a very important part. I believe it *is* logical to view internal auditing as a part of internal control. It is the delegation of the management monitoring function to a separate internal audit group. I don't think one should view this as a tail wagging the dog. Indeed, in large systems the monitoring system may grow almost as complex as the system it monitors. But this is merely analogous to EDP housekeeping controls using up almost as much space as the actual working program they are controlling.

Conclusion

In summary, I thought the paper gave an interesting overview of the historical development. As in all overviews, it is something that could also be expanded—and indeed, might be of considerable interest in a more expanded form. The principal areas where some expansion might be of interest would be, as I have suggested, feudal England, Renaissance Italy, and the coming of Companies Acts to England, together with a comparison of the subsequent developments in the United States, England, and Canada.

2

Management Behavior—An Auditing Horizon

W. Donald Georgen
Touche Ross & Co.

The independent accountant has—and always had—a responsibility to look for management fraud and illegal acts. Less clear is the auditor's responsibility to discover these activities if they have occurred. The professional literature is ambiguous, and the recent Supreme Court ruling in the Hochfelder case did little to resolve the uncertainty. Speaking practically, however, the profession must face up to the expectations of the public. The question is not whether we have any responsibility in these areas—the real questions today are, how far does that responsibility go, and how should the independent accountant go about executing that charge.

While not new, this responsibility is being given considerable attention by practitioners, academicians, and regulatory agencies, as well as the courts, because of the sensational disclosures recently regarding implied improprieties (most of which have not been proved conclusively), management fraud, and illegal payments. The public is concerned and dismayed, not only that such events could have happened, but also that they were not detected and reported on a timely basis. Ultimately, that concern focuses on the independent accountant. In the public view, the independent accountant has the best opportunity (and therefore the responsibility) to determine that proper controls are operative to prevent such events, or where those controls fail, to timely detect and report the events. The public must acknowledge that independent accountants will never be able to guarantee that all instances of management fraud and other illegal acts have been detected—but on the other hand, it is my opinion that our detection "hit rate" must be substantially improved.

Attributes of Management Fraud and Other Illegal Acts

Before we attempt any analysis of the auditor's responsibility, we have to examine the attributes of management fraud (and analogously, illegal acts). Also, we must look at the traditional audit approach to see how it might be changed.

Fraud, very simply, is a deceptive practice—one where the perpetrator hopes to avoid detection. (Armed robbery is not a fraud, because the overt act is obvious.) Frauds in the business environment fall into two broad categories—those occurring at the employee level and those occurring at the management level.

Employee frauds generally have two basic characteristics:

—The object of the fraud is to convert cash or merchandise to the individual's benefit.
—The activities of the employees are or should be covered by an effective system of internal control. Although an effective system will not prevent all acts of employee fraud, it should provide for early detection and preclude frequent repetition.

The characteristics of management fraud are significantly different:

—Generally, fraud at the management level does not involve direct theft of cash or merchandise; instead, it often involves "performance" fraud—the deceptive practices result in high reported earnings or they forestall the recognition of a decline.
—Indirect benefits accrue to management from the fraud—salary, bonus, profit sharing, and/or value of stock options may be improved or preserved, and the likelihood of continued employment is increased.
—The fraud is likely to operate outside of established business systems and related internal controls—in other words, the bosses are not subject to the system.
—The nature of the deceptive act is not always apparent, for it may be difficult to determine whether deception or error in judgment is involved.

I would particularly like to emphasize the last two points. Management most often has the ability to operate outside the system, simply because it is generally the top point of control in the system. And the independent accountant is often unable to distinguish deception from an "honest mistake"—at least until subsequent discernments provide a clue to management's motives. These two points underscore our dilemma. The traditional auditing approach is not really effective against management fraud. Also, the traditional audit approach, which is independent and neutral, does not focus on the judgments necessary to evaluate the qualitative aspects of management activity.

The Audit Approach

Given the characteristics of management fraud, let us take a critical look at the usual audit approach. Traditionally, generally accepted auditing standards have allowed the independent accountant to assume that management's behavior will conform to a predictable, set pattern. In other words, although he should be alert to fraud opportunities, the auditor's primary objective is the gathering of sufficient evidential material to form a series of judgments leading to the expression of a professional opinion on the financial statements—*not* the detection of fraud. The auditor's conventions tell him to gather "enough" of the "right kind" of audit evidence. Although there are conventions which give guidance to the determination of "enough" and "right kind," the auditor's judgment in the particular situation is the principal determinant of audit scope.

Does this suggest that the auditor's scope or approach has to be changed to improve the fraud detection rate? The answer is probably yes. Does it suggest that all audits should be performed in the fraud mode—where you turn over every stone and peel every grape? The answer is categorically NO! The cost to society would be prohibitive, given the relative number of actual frauds perpe-

trated. And more importantly, given a dishonest management, the independent accountant would never be able to do enough work to satisfy himself—or anyone else—that *all* acts of fraud were detected. We simply cannot assume the total responsibility for fraud detection, if we are to be honest with ourselves and society. However, in the same breath I have to admit that we have to be concerned with the consequences of the relatively few frauds. And even though we can't catch them all, I am convinced that we can catch substantially more than we have in the past.

Coping with Fraud

In my judgment, it's a matter of working "smarter" rather than "harder." We say that the auditor's responsibility in the attest environment is to make an "informed judgment"—and I think the way to improve detection of fraud lies in that phrase. Further, I don't believe exponentially exploding the number of transactions tested and accountabilities verified necessarily results in a more "informed judgment." Although the scope of the evidence gathering is always important, the quality of the information gathered, how it is obtained, how it is correlated, and the overall evaluation process are equally important in arriving at an "informed judgment."

Our firm has spent considerable time and effort in developing an approach which we believe will make us more effective in the detection of management fraud. The procedures are not new, but the emphasis is. The program has basically three features; and they are all related:

—an effective client investigation program *before* we commence a new engagement and a similar periodic update on continuing engagements;

—an in-depth understanding of the client's business—the economic conditions, the inherent control problems, the peculiarities of the industry; and

—concentration on material transactions—to determine their true nature and their arm's-lengthness, and to determine the proper accounting and the required disclosures.

Client Investigation

The client investigation feature of this approach puts emphasis on determining the reputation of the company and, in particular, its management. The questions asked and the information gathered are intended to answer the question—is this a company and are these people with whom we want to professionally associate? Is there any reason we should not associate?

Some will argue that this "exclusiveness" is socially irresponsible. Some will argue that all public companies are entitled to the services of an independent accountant. However, society has decreed that an independent accountant's investigative tools are to be limited—there is no subpoena power and no right to take testimony under oath. Instead, society has inculcated that there be a professional relationship between independent accountant and client. Within that structure, I believe the independent accountant is entitled to accept professional associations with care—indeed, I believe care is essential.

Understanding the Client's Business

Understanding the business is part of the client investigation routine which carries over into the establishment of scope or depth of the audit. Here we concentrate on:

—who is management, or who can make the business decision (Appendix A);
—in what roles does the management group operate (Appendix B);
—what economic factors are present in this industry—in this company—which would be conducive to encouraging or enhancing the fraud opportunity (Appendix C);
—what is the business structure, and would it facilitate or prevent the management fraud act (Appendix D).

When we have gathered, correlated and evaluated this information we then identify the areas of risk and set the scope of our audit procedures relative to the degree of risk. The evaluation is a professional judgment—but a professional judgment based on the relevant facts. Occasionally, based on our evaluation, we will say that the business factors individually or collectively present a risk situation which we cannot audit. In these circumstances we should—and have—withdrawn from the engagement.

Material Transactions

The third feature of our approach is a concentration on material transactions. Again, this part of our approach carries over from the client investigation and our efforts to understand the client's business. We *do not* pick a random selection of transactions and accountabilities and look for management fraud. Rather, we first identify all material transactions and accountabilities and then analyze those transactions in depth, for management involvement and its consequences. In the absence of direction from the profession, the regulatory agencies, or the courts we have established the following standards of "materiality" for this process:

—balance sheet items—measured at 5 percent of total assets
—shareholders' equity items—5 percent of total shareholders' equity
—income statement:
  —sales or purchase items—10 percent of total sales or purchases
  —operating income or expense items—5 percent of income before extraordinary or unusual items
  —nonoperating items—5 percent of pre-tax income

When we have identified a material transaction in which management or a related party is involved, we audit to evaluate the transaction and the nature of the management involvement. We study the transaction so that we can ask for and obtain the relevant documentation—we want documentation, *not* conversation. We then go one step further and request independent confirmation *of the details behind the transaction.* This is an important distinction from the traditional approach. We go beyond the normal confirmation of transaction timing, amounts involved, balances due or owing, and terms. We specifically ask for

confirmation of *all of the facts*—previous, continuing, and prospective—which are conditions of the transaction. This procedure is intended to determine if there might be additional documentation or even unwritten understandings which override the available records.

A Professional Overview

Our approach, although now in effect for 18 months, as a "state of the art" is still in the development stage. Other firms are experimenting with their programs under the general guidance of SAS 6 of the AICPA on "Related Party Transactions." The usefulness of this approach to fraud detection will evolve as we all gain more experience. I seriously doubt if any "brand new" audit procedures will come out of these efforts, but the auditor's attention will be directed more explicitly. A management fraud approach must put emphasis on informed judgment, insist on substantive rather than mechanical analysis, encourage probing of material transactions for a better understanding of the facts, and in general promote a "healthy skepticism."

In the late '60s and the early '70s a number of famous management frauds surfaced. More recently, another, more wide-spread form of illegal activity has come to the fore. The press has been full of stories of illegal political payments, slush funds and apparent bribes. Again, the public is asking, where was the independent accountant?

Illegal Payments

As I indicated earlier, it is my judgment that this illegal payment problem is analogous to the larger management fraud problem, insofar as it challenges the role of the independent accountant. This is true because illegal acts are often the product of management's direct involvement or indirect forebearance because of industry practices, economic conditions, or systems and control weaknesses.

But let's put these problems in their proper perspective. The public arousal over illegal payments and the cries for disclosure and "cease and desist" are in my judgment a product of the Watergate environment. Illegal payments are not a new phenomenon on the business scene, as evidenced by present disclosures. Many of the news stories report questionable payments, covering an extended prior period. Why was there not earlier concern over these practices—by the public, the regulatory agencies and independent accountants? While many will profess ignorance—and I suspect most people were not aware of the widespread nature of the practice and the huge sums involved—I believe that, as a result of the concept that these payments are "accepted business practice," the problem was generally ignored.

Without going into the developing morality or flailing ourselves for past omissions, I am willing to say that I believe it is our responsibility, as independent accountants, to be satisfied that our clients' audited financial statements taken as a whole contain adequate disclosure, and provisions for the financial effects (where applicable) of illegal payments. In the absence of direction or standards from the profession and the regulatory agencies, however, the specific ground rules for accomplishing this responsibility are very unclear.

Rather than philosophize as to the ultimate direction the profession will

take, I would like to share with you the policies and practices that we have adopted, in our firm, to deal with the subject of illegal payments.

We have decided that we *cannot* define illegal payments per se. We say this determination is ultimately a judicial question and an opinion—as to legality or illegality—can only be given by competent legal counsel. We then treat the subject based on defined illegal payments and "possibly" illegal payments. As in our approach to management fraud, we have identified possible situations where illegal payments may be expected. The purpose of this initial analysis is to direct the audit emphasis. For example, the independent accountant should be alert for the possibility of illegal payments when the client sells in countries where those business practices are expected, or where there are substantial cash transactions, or where there are significant "soft expenses." We have also developed standards of materiality in determining the scope of our examination for such payments.

Where we have knowledge that an illegal or possibly illegal payment has occurred, we require:

—that the matter be discussed with the client's board of directors;
—that an opinion be requested from the client's legal counsel as to the legality/illegality of the payment, the requirements for disclosure under the securities acts, and the form and content of that disclosure;
—consultation with our national technical staff; and
—finally, an objective evaluation of all the information and the legal opinions to determine the propriety of financial presentation and disclosure, and the impact, if any, on our auditor's report.

Although we are once again in a "state of the art" situation without specific direction from the profession, regulatory agencies or the courts, we believe our program is focused on the essentials of the problem—detection and disclosure.

Some Concluding Observations

In talking with you about management fraud and illegal payments, I have tried to avoid any suggestion that we were talking about specific procedures or standard steps. And I particularly want to emphasize that we are talking about an integrated whole. Or said a different way, we think this approach is simply a re-emphasis of the business approach to auditing—defining the "business approach" in the broadest possible terms.

As a result of thinking through the approach to management fraud and illegal payments, we have given more thought to our overall audit objective. It is apparent that a successful audit depends on more than program details. It is apparent that a proper attitude or philosophical audit approach is necessary. For the last several years, we have summarized these "truths" in a year-end audit reminder to our professionals, and I would like to share them with you:

- Our assignment is to independently challenge and evaluate, *not* to rationalize.
- When we say we want to emphasize the "business approach" to auditing, we mean do the reported facts make business sense—*not* can we support what management has concluded.
- On each engagement, we have to ask the question—are the statements

auditable? We have to make a rational judgment; the conclusion is *not* a given assumption.

- Emphasis has to be placed on a basic evaluation of evidentiary material—*not* a mechanical analysis of reported transactions and accountabilities.
- Audit evidence must be based on factual documentation, *not* conversation.
- Accounting and reporting matters are governed by generally accepted accounting principles. In many areas GAAP parameters are fairly broad. In the application of accounting principles we have the responsibility to determine the appropriateness of the principles in the circumstances.
- The responsibility to perform an effective audit of the facts is just as important as the proper resolution of accounting and reporting issues. We have to guard against a preoccupation with the solution of accounting and reporting issues to the exclusion of the audit of the underlying facts.
- We need the appropriate level of audit management involved on all audits. A significant part of the audit process is evaluative and judgmental. The skills necessary to execute these qualitative factors are developed largely through experience. We cannot delegate experience. We cannot delegate these judgments in the critical areas of the engagement.
- The development of audit skills requires a basic methodology; a disciplined approach and experience. The methodology can be taught and experience is a product of time and variety of engagement assignments. Development of a disciplined approach is dependent on the environment in the office in which the professional works and the perceived attitudes and work habits of those for whom he works. The development of a proper disciplined approach from the bottom up can happen only if we have a properly disciplined approach at the top—in the management group.

In my opinion, the problem of illegal payments will largely disappear in a relatively short time. The public outcry, the pain and embarrassment of public disclosure and censure, tighter corporate policies and controls, closer scrutiny by boards of directors and others, and specific Federal regulations will effectively limit these practices.

Management fraud, on the other hand, is with us and is not going to go away, in the absense of any moral uplifting. The pressure for earnings growth has been a catalyst for management fraud in a stable or accelerating economy; the pressure for survival in uncertain economic times may be an even greater stimulant. We can say that other disciplines—the board of directors, the audit committee, the public and the regulatory agencies—have a responsibility to force management integrity. But we cannot deny our own responsibility. We can say that we can't catch them all—and this is true—but we have to catch more of them. Some will say that making an independent accountant look for fraud is an unreasonable burden; I would suggest to you that a properly balanced responsibility offers us an opportunity to attain top professional status.

Appendix A

Who is management?

- Officers
- Directors
- Associates
- Affiliates
- Trustees
- Partners
- Co-venturers
- Principal Stockholders
- Others

Appendix B

Management Involvement Role

- Buyer
- Seller
- Guarantor
- Lessee
- Lessor
- Forebearer
- Debtor
- Creditor
- Nominee
- Franchisee
- Franchisor
- Licensee
- Licensor

Not intended to be all-inclusive

Appendix C

Some Conducive Economic Factors

- Insufficient working capital or credit
- Urgent desire for good earnings to support stock price
- Developing industry—massive demand for new capital
- Dependence on a very few products, customers or transactions
- Debt restrictions binding
- A declining industry with many business failures
- Company with excess capacity
- Many lawsuits, especially from shareholders
- Rapid expansion or numerous acquisitions, especially in diversification
- Collection difficulties from key customers, for instance, REITs
- Inventories requiring non-auditor expertise
- Long-term manufacturing cycle
- Unrealistic sales projections
- Obsolescence danger—high technology industry

Appendix D

Examples of Conducive Business Structure

- Dispersal of locations, documents, evidence
- Diversified company and accounting systems

- Management dominated by one or few
- Divided audit responsibility
- Inadequate internal audit function
- Extreme mobility in key financial positions
- Mobility or lack of outside legal counsel
- Constant crisis mode in accounting function
- Numerous substantive adjusting entries in audit closing

Discussant's Response to Management Behavior—An Auditing Horizon

Robert L. Grinaker
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Although I am pleased to comment on Donald Georgen's paper, I also have something of a problem because, to a large extent, I agree with most of the things he has to say. It's a little difficult to discuss a paper that I wish I had written myself. Hence, I would like my remarks to be considered complementary to, rather than critical of, those presented in the paper. My discussion will be directed to the following specific topics:

A. Under the broad area of auditor's responsibility, I shall make a few comments on management fraud and illegal payments.
B. I shall address the following three additional topics:

   1. Evaluation of traditional auditing procedures.
   2. Understanding the client's business.
   3. Scientific research design—a prototype for auditing procedures.

Auditor's Responsibility for Management Fraud

Let me first comment that Don Georgen makes a very useful distinction between employee and management fraud. Furthermore, I agree with him that most instances of management fraud are "performance" based rather than involved in the direct theft of assets. However, certain classical cases—notably McKesson-Robbins—did involve massive thefts of company assets.

I further agree that the profession is becoming increasingly aware that it has significant responsibility for the discovery of management fraud. I also am convinced that this awareness stems principally from public expectations which are reflected in actions of regulatory agencies and the courts. The processes appear to be by-passing the auditor, thus posing some significant dangers. To me, the danger is that the auditor's responsibility for fraud losses may be completely disassociated from financial statements and their fair presentation. In my judgment, the only perspective that makes sense in defining the auditor's responsibility for fraud is its relationship to the fair presentation of the financial statements. In this regard, our professional literature, characterized in the paper as ambiguous, has been something less than helpful. Consider the following from AudSEC's Statement on Auditing Standards No. 1:

> In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentations by management, or both. The auditor recognizes that

> fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. (§ 110.05)

The foregoing seems to be a very clear statement right on issue. Fraud is identified as a source of error and the auditor is aware of the fact that *any* material error, including fraud, can have an impact on the fairness of the financial statements. If this be so, the auditor's opinion and his responsibility are affected. If the statement stopped here, I would conclude that the auditor's responsibility for fraud is no different than for any other source of misstatement. I could then argue with force that, although the auditor must conduct his examination with due professional care, he is not a guarantor. Hence, despite an examination conducted in accordance with generally accepted auditing standards, material error may nevertheless remain undetected. Whether the source of the misstatement is fraud or honest error should be irrelevant.

Unfortunatly, AudSEC's statement continues, and like negative assurance, the meaning of an otherwise clear statement is considerably blunted. The next three sentences read as follows:

> However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentations by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and other) arises only when such failure clearly results from failure to comply with generally accepted auditing standards.

What are these latter sentences attempting to say? Are they saying that the auditor is not responsible for detecting immaterial fraud? Or, are they saying that the auditor's responsibility for detecting error arising from fraud is different than for other kinds of error? For example, is the responsibility different in the case of an honest error arising from the failure to account for obsolete inventory compared to an error arising from management deceit? If so, the auditor's opinion should be redrafted. On the other hand, the statement may simply be pointing out that the auditor is not infallible. Hence, errors of any kind may remain undetected even though the auditor has conducted an examination in accordance with generally accepted auditing standards.[1]

In any event, the statement as now drafted is ambiguous. Hence, any position inferred from this statement may be totally right or totally wrong. A clearer statement may not help, but I believe it would have a better chance than the current one.

As to whether the auditor should specifically search for fraud, or any other source of error, I would assert that the audit mode should always be applicable to the circumstances. I believe that this statement simply generalizes from Don Georgen's position that his firm would audit in the fraud mode only in warranted circumstances—i.e., where the economic and other conditions may be conducive toward fraudulent activities. Rightly so, extensive tests are made in the fraud

mode only in those circumstances where fraud is likely. But surely the general position also is right; i.e., extensive special tests of any kind should be warranted by the circumstances. For example, if I am auditing a highly technical industry, characterized by ever-changing product specifications, I will certainly apply rather special, and perhaps costly, tests for inventory obsolescence. Such tests would be totally unwarranted in other circumstances. I make this point not to be pedantic, but to support the position that fraud should be classified together with all other possible source of financial statement error.

The Auditor's Responsibility for Illegal Payments

With respect to the auditor's responsibility for illegal payments, I hesitate to speak other than to confess my confusion. I am not greatly helped by recent court decisions or by statements of SEC Chairman Hill. I could, perhaps, understand the auditor's responsibility if it were related to either of the following circumstances:

a) If failure to disclose such payments would cause financial statements to be materially misstated, or
b) If the auditor had witnessed a crime and the failure to disclose were viewed as a conspiracy to cover-up.

Thus, I find myself in agreement with Don Georgen that our responsibilities in this area remain unclear. In the meantime, I believe his firm's position is exactly appropriate—i.e., audit in the "illegal payment mode" in those circumstances where illegal payments are likely to have occurred.

Evaluation of Traditional Auditing Procedures

In any consideration of the auditor's responsibility for the discovery of fraud, traditional auditing procedures warrant some attention. A number of traditional auditing procedures are directed to fraud detection. For example, since 1940, as the consequence of a classic case of massive management fraud, at least a portion of almost every audit is conducted in the fraud mode. In my judgment, a critical review of traditional auditing procedures would prove fruitful in suggesting modifications which could materially enhance the probability of discovering management fraud. I would like to use confirmation procedures as a caged example.

In discussing auditing procedures, we often speak of independent confirmation, in which we represent that testimony is communicated directly from an independent third party to the auditor. To assure such independence, we take some pains with the processes involved. As a personal indication of these concerns, I once received some pointed criticism as a young auditor from a partner who observed my intention to mail out confirmation letters in the client's envelopes. Never—before or since—have I heard such a lucid explanation of the importance of assuring independence in the confirmation process. Now, in the Equity Funding case, we find revealed another significant "hole" in the process of independent confirmation. Although Equity Funding was replete with questionable auditing, the case also contains some significant lessons.

You will recall in the case that the auditor attempted to confirm the existence of securities in the custody of a bank. However, he got burned by a very simple

ploy, totally unrelated to such traditional controls as "using the right envelopes" or "delivering of confirmation requests directly to the postal authorities." The special AICPA Committee investigating Equity Funding describes the ploy as follows:

> At the end of 1972 the auditors' request for confirmation of certain securities represented as being held in safekeeping by the bank was addressed by company personnel to a mail drop set up under a name similar to the bank so company personnel would receive the request, sign the confirmation and return it to the auditors.[2]

I wonder, are traditional auditing procedures adequate with respect to this matter? The special committee concluded on the issue with the following statement:

> While this points up the need for auditors to ascertain that valid addresses are used, such a step is already a customary and integral part of confirmation procedures.[3]

Frankly, I would like to see the empirical evidence which supports the foregoing conclusion. My own evidence, while admittedly limited and informally gathered, indicates that tests of the validity of confirmation addresses generally is limited to data contained in the client's records. If so, I suggest that such tests are inadequate to assure independent confirmation.

In summary, based on my admittedly caged example, I suggest that traditional auditing procedures be subjected to continuing critical review on two fronts: first, we should test the logical connection between each link in the evidential chain, and second, we should study subsequently discovered misstatements not revealed in the auditing process. If auditing weaknesses are revealed, normal audit procedures should be corrected.

Understanding the Client's Business

A so-called "through the business approach" has been discussed in auditing literature, and particularly by Touche, for a number of years. I am pleased to note that the client investigation routine discussed by Mr. Georgen places special emphasis on "understanding the client's business." I have come to believe that thorough prerequisite knowledge of the client's business is absolutely essential to effective auditing and, hence, to the discovery of material error—whether the source is fraud or an honest mistake.

My conviction on this point finds clear support in philosophical literature dealing with the theory of knowledge. Marhenke states as follows, "You cannot devise an observation test until you know the meaning of the sentence you are going to test."[4] For example, with respect to auditing, consider the following sentence: "The inventory value on the balance sheet is fairly stated." To test this sentence, the auditor must know not only the general meaning of inventory and inventory accounting, but also the special environment in which this particular inventory is contained. Many special problems such as identification, physical condition, or obsolescence may be involved. If such special problems *do* exist, they form part of the meaning of the sentence to be tested.

In discussing the nature of scientific inquiry, Susan Stebbing reinforces the point with the following statement:

> An examination of the examples we have given shows that a considerable amount of previous knowledge relevant to the situation is required before a problem can even be stated. Still more knowledge is required in order that fruitful suggestions as to its solution should occur to the thinker.[5]

One may rightfully question why I am belaboring such an obvious point. Consider the following statement by the SEC in ASR No. 173 issued in July, 1975:

> Another lesson appears . . . where the auditors accepted assertions by management concerning the special circumstances of the business involved although presentation of the supposed results presented unusual accounting and auditing problems. In considerable measure this occurred because the auditors were not sufficiently familiar with the business context to assess the representations of management. Auditors should be particularly careful when the client asserts that special circumstances require unusual accounting or auditing solutions and should either possess or avail themselves of sufficient industry knowledge to judge the substance of the situation.

In ASR No. 174, under a caption entitled "HFK's Understanding of Stirling Homex's Business" is the following statement:

> HFK, in the opinion of the Commission did not fully understand the funding provisions applicable to Stirling Homex's operations under the HUD turnkey program and did not seek such advice.

As was asserted by the SEC in these two ASR's, failure to understand the client's business accounted for the failure to obtain competent evidence from which appropriate inferences could be drawn. More fundamentally, the auditors in these cases could not devise the proper observation tests because either (1) they did not know the meaning of the sentences they were trying to test, or (2) they did not know enough even to formulate appropriate propositions to be tested.

In my judgment, prerequisite knowledge of the client's business is so fundamental to inquiry that steps should be taken to assure that such knowledge pervades the entire audit team. Much prerequisite knowledge is provided to younger staff members by recent university education and in follow-on staff training programs. However, I wonder how many staff training programs are directed to specific industries and specific clients. I assert that inclusion of such programs in the training budgets of accounting firms would be cost-beneficial. Although I have no evidence in support of my assertion, I believe the concept can and should be empirically tested.

Scientific Research Design—A Prototype for Auditing Procedures

Georgen points out in his paper that auditing procedures—particularly those procedures directed to the discovery of management fraud—are in the development state. As a matter of fact, all human knowledge is tentative and, hence, is subject to continuing mid-course corrections. Auditors will continue to learn both from past mistakes and from research. As we learn more, auditing procedures will continue to become more effective in the discovery of fraud and other error.

Experience, of course, is a great teacher. As some sage so wisely stated, "Fool me once, shame on you; fool me twice, shame on me." The SAS's are replete with auditing lessons learned from experience. However, the lessons of experience are

often bitter pills to swallow. Hopefully, therefore, we will come, more and more, to rely on research for the development of auditing procedures. Research already has proved fruitful in the development of opinion modifications, understanding the application of statistical inference to auditing, and understanding the impact of the behavioral sciences on auditing.

Compared to most other disciplines which evolve through research, auditing is unique in that a significant portion of the discipline itself comprises a system of inquiry. Thus, the principles of scientific research design stand as a ready-made prototype for the investigative aspects of auditing. In my judgment, a significant positive step in the development of auditing procedures would be recognition of this relationship by an authoritative professional body—say, AudSEC.

Every developing discipline has found that its problems begin to yield solutions when the methods of organized inquiry are applied. We are just beginning to tackle accounting and auditing problems in this fashion. Despite the many difficulties involved in getting started, a number of problems are yielding solutions. In my judgment, one of the blessings of the current high demand for accounting education is the concurrent demand for accounting doctorates—young people specifically trained to be researchers. The important point for auditing as a discipline is that research education implies the existence of a body of knowledge specifically about the research process. Because auditors, like trained researchers, are involved in a system of inquiry, I assert that, if all auditors were specifically trained in the general methods of research design, auditing procedures and their ability to detect fraud and error would be significantly improved. Although I have no evidence to support my assertion, I am convinced that the concept can and should be empirically tested.

In Summary

In summary I would suggest the following:

1. Fraud (and perhaps illegal payments) should be viewed by the profession as simply another possible source of financial statement error with responsibility and consequences no different than for any other source of error. Auditors would then be in a better position to address with force the questions of due professional care vs. professional infallibility.
2. So-called traditional auditing procedures should be subject to continuing review for logical "holes." Such review should assure maximum effectiveness of normal auditing procedures to detect fraud and other errors.
3. Thorough understanding of the client's business is an essential prerequisite to effective auditing and, hence, to the detection of fraud and other error. I further suggest that staff training be geared to developing the means of obtaining such an understanding by every member of the audit team.
4. Because auditing is a system of inquiry, scientific research design should be adopted as a prototype for the investigative aspects of auditing. I further suggest that all auditors be trained in the fundamentals of research design.

Footnotes

1. In May, 1976, AudSEC announced the issuance of an exposure draft entitled *The Inde-*

pendent Auditor's Responsibility for the Detection of Errors or Irregularities. The questions raised here may be answered by this statement.

2. *Report of the Special Committee on Equity Funding,* American Institute of Certified Public Accountants, 1975, p. 23.

3. *Ibid.,* p. 32.

4. Paul Marhenke, "The Criterion of Significance," *Meaning and Knowledge: Systematic Readings in Epistemology,* Edited by Ernest Nagel and Richard B. Brandt, Harcourt, Brace & World, Inc., New York, 1965, p. 35.

5. L. Susan Stebbing, *A Modern Introduction to Logic,* Harper & Row, New York, 1961, p. 238.

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Symbolism and Communication in the Auditor's Report

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The 1975 annual report of Arthur Andersen & Co. indicated that 6.6% of the firm's total revenue was received from five clients.[1] Simple arithmetic applied to the total revenue figure leads to the conclusion that Arthur Andersen had five clients whose annual fees average about $5.1 million each. Using other averages given, the audit fee portion of the total was about $3.4 million for each client. Additional analysis of the data provided in the report suggests that $3.4 million of auditing fees would represent about 95 man years or 128,000 hours of work. Obviously, the precision of these manpower estimates is subject to some doubt, but even with a wide range of possible inaccuracy it is obvious that $3.4 million worth of auditing represents a prodigious expenditure of skilled accounting labor.

Arthur Andersen did not indicate the particular clients that were the beneficiaries of this lavish scrutiny. One might assume that the group includes International Telephone and Telegraph Corporation, and Texaco, Inc., two of the largest corporations in the world that are AA clients. Additional candidates among Arthur Andersen clients, considering size and complexity, might be UAL, Inc. (United Airlines), General Telephone & Electronics, and Occidental Petroleum.[2]

Let us assume, for purposes only of a simple but significant point, that the above five corporations are, indeed, the five large clients referred to in the Arthur Andersen & Co. annual report. Then, approximately 17 million dollars, 475 man years, or about 640,000 man hours were expended in their audits.

The Audit Reports to Five Largest Clients

A brief, but rigidly conducted empirical study indicates that the audit reports to the shareholders of these five companies for the year 1974 (the audits most likely to have been performed in the Andersen fiscal year ended August 31, 1975), include a total of 875 words, or an average of 175 words each.[3]

Now consider the significance of this arithmetic. Arthur Andersen & Co. was required, within the confines of present, conventional practice, to communicate to tens of thousands of shareholders and other users, the nature, intent, scope, quantity and results of the equivalent work of 95 professionals laboring for a year, in about 175 words—and no pictures.

This, then, is the nub of the problem. Tradition, conventional usage, and ultimately the pronouncements of the American Institute of Certified Public Accountants have developed a scheme whereby the auditor confines the report of

the results of an examination to a few dozen words; a few hundred if unusual complexities or exceptions manifest themselves.

Audit Reports in Evolution

Audits, as they commenced around the start of the 20th century, involved a fairly simple and straightforward verification of the existence of the company and its assets along with some assurance that substantial proportions of the wealth of a usually small number of shareholders had not been misappropriated by untrustworthy stewards. Since then, the corporations being audited have grown to staggering complexity and the auditor is now expected to attest the accuracy of the measured performance of management's attempts to maximize the wealth of hundreds of thousands of generally uninformed and disinterested investors.

One might have expected that the vehicle for the auditor's communication of audit results would have undergone some comparable evolution, but that does not seem to be the case. Early audit reports issued in the United States (from 1900 until after World War I) tended to be relatively brief:

> We have audited the books and accounts of the XYZ company for the year ended December 31, 1915, and we certify that, in our opinion, the above balance sheet correctly sets forth its position as of the termination of that year, and that the accompanying profit and loss account is correct.[4]

It appears that some "long" or descriptive "certificates" were issued in the 1920's. D. R. Carmichael gives two examples: 1924 reports on American Locomotive Company and General Electric Company.[5] The report of American Locomotive includes a number of statements which essentially describe the valuation practices employed in the financial statements and provide an indication that proper accruals have been made. The General Electric report includes not only some valuation practices, but also a listing of many of the audit steps performed.

Nevertheless, as described in an unpublished background paper prepared for the Commission on Auditors' Responsibilities by Terry Aranoff, despite a number of wording changes, the opinion remained a brief, substantially unchanged document.

References to conformity to generally accepted accounting principles and to generally accepted auditing standards were both included by 1941. The "short form" opinion probably reached a maximum modern length in 1941, when it also included a reference to a review of the system of internal control. Thereafter, the report evolved to the present standard opinion, accompanied by such critical debate as to the number of paragraphs which should be used.

The Communication Issue

Having established, or at least described, the massive communication problem that faces the auditor, I promptly disclaim any attempt in this paper to "solve" or offer a "solution" to that problem. This reluctance to grapple with the major problem stems not from limitations of space or time, but of knowledge. I would have preferred to offer a comprehensive approach to the communication issue. The staff of the Commission on Auditor's Responsibilities has developed several background papers that relate to the subject, including a long work on the history

of the auditor's opinion. The Commission has discussed the problem at length and a tentative paper has gone through several drafts.

Notwithstanding this impressive volume of work and thought, there are few really new insights into either the problem or the solution. In short, I do not know the answer, and hence I cannot write a paper that provides one.

However, some of the work of the Commission (that of one researcher in particular) and a modest amount of informal inquiry by the writer suggest that one element of the problem may have been missed in the past, or at least, not explored in enough detail. That element lies essentially in the description—and therefore nature—of the auditor's communication device. The auditor's message to the reader of audited financial statements has variously been styled as the "opinion," the "report," or the "certificate." The last appellation appears to be in some present disrepute, probably because of the degree of certainty it implies.

The hypothesis of this paper is simple. The present auditor's report is not a certificate, a report, nor an opinion; it is a symbol. It is a symbol not only to the socalled unsophisticated user, but to the informed, professional investor as well.

The Report as a Symbol

The mere observation that the auditor's report is a symbol, or at least the implicit suggestion that the report functions in a symbolic manner is not novel. However, it appears that intimations that an auditor's report is a symbol are generally taken as a negative factor in the communication problem. There also appears to be a prevailing opinion that if the auditor's report is not carefully read by each user, it cannot convey the complex message that it contains.

I suggest that if the auditor's report is essentially a symbol, then these limiting interpretations do not follow. To the contrary, if users do perceive the auditor's report largely as a symbol, then it can indeed convey the highly complex message that must inevitably result from the previously described enormous labors of the auditors.

The Nature and Use of Symbols

The classic 11th edition of *Encyclopedia Britannica* defines a symbol as ". . . a visible object representing to the mind the semblance of something which is not shown but which is realized by association with it."[6]

Modern analysis of symbols, signs and dreams, and the vastly increased use of symbolic logic in the sciences appear to have outdated both the "visible object" element of the definition, and even the ability of *Britannica* to provide a brief discussion of the subject. The current edition prefers to discuss "symbol" under a number of different subject areas, but not under its own.

Freud and some of his interpreters, however, broadened the concept of symbols enough to permit themselves, at least, a brief definition. Erich Fromm suggests that a symbol might simply be, "something that stands for something else."[7]

A symbol may merely be a visual abbreviation of a more complex object. Thus, the stick figures drawn by children serve to represent the full human figure. More commonly, and certainly of greater significance, a symbol may be a visible representation of an object, idea or concept which bears no clear resemblance to the physical appearance of the symbol. In chemistry, alphabetical symbols represent

the elements. In mathematics, symbols may be used to represent that which cannot otherwise be conventionally represented; such as π or ∞.

Symbols, of course, are a major element in religion. The Greeks and Romans made direct representations of their Gods. The serpent represented evil in the first verses of Genesis and continues as such a representation to the present day. St. Peter is represented by keys; St. Paul by the sword. The principal symbol of Christianity, the cross, demonstrates the extraordinary power of a simple symbol to convey several different and sometimes extraordinarily complex messages. It may serve as the identification of a believer, as a protection against evil or the devil, and ultimately, as instant representation of an entire set of beliefs and teachings.

Symbols play a major role in the modern world. The red star of Communism carries a vivid message to millions; a message that tends to contradict the symbol of Uncle Sam. However, while the rigidity of the five pointed red star largely defies artistic manipulation, the American symbol, Uncle Sam, is more flexible. He looks sternly demanding on the classic U.S. Army recruiting poster; slightly confused in Bob Grossman's liberal cartoons in *New York Magazine*; and threateningly sinister in his *Pravda* version.

Thus, the same symbol may carry substantially different messages to different viewers. Actual alteration is not necessary. The red star means one thing to a member of the Russian Communist party, another to a member of the U.S. Republican party. Undoubtedly, a late 15th century Christian perceived a somewhat different message in the symbol of the cross than did a non-believer of the same period, being subjected to the not so tender recruiting techniques of the Inquisition.

These differences in perception of the identical symbol stem from essentially different attitudes towards the underlying meaning of the symbol. The symbol is understood but its message is valued differently.

Differences in the meaning of a symbol may also occur because of misunderstanding or confusion about the symbol. A red traffic light is a symbol indicating "Stop" to most drivers. The symbol may not exist to the color blind driver who misses the message. In this case, the difference in perception of the symbol is the fault of the viewer. One assumes that the issuer of the symbol would prefer that all viewers make the same, unambiguous interpretation.

In a contrary vein, different symbols may be perceived to be the same symbol. Certainly a major component of many advertising campaigns is the hope that just such confusion will occur. For example, it seems clear that some automobile designers believe that consumers perceive the unique front grill design of the Mercedes automobile to be a symbol of the quality of the car. Therefore, it apparently is no coincidence that both the new Ford and Chrysler "quality" compact cars sport grills that are almost identical to that of the Mercedes.

Symbol Recognition

Logic suggests that visual complexity plays a role in increasing or decreasing the possibilities of correct *recognition* of a symbol. Thus, a circular symbol would rarely be confused with a square one. However, symbols based on six-sided polygons might well be confused with octagonal symbols. The current economic and legal perils of such confusion of similar, but different symbols were recently demonstrated and well publicized when the highly paid creative staff of the

National Broadcasting Company labored and brought forth, at great expense, a television identification symbol that was almost identical to that generated at virtually no cost by the Nebraska educational television organization.

The problem of uniform symbol *recognition* is quite different, however, from the problem of *understanding* or *interpretation*. Thus, virtually all drivers will recognize a "Drive Safely" sign; they may interpret and implement the message in quite different fashion.

Developing Symbols

The previous illustration leads to another basic point; symbols are not confined to figures, signs or shapes. A language is essentially an aggregation of symbols. Each word is a symbol for a thing (noun), an action (verb), or a quality (adjective or adverb). However, the use of symbols as language is a conventional or neutral usage. There is no linkage between the form of the word-symbol and the object, action or quality represented. Thus, the letters b-o-o-k are merely the conventional representation of the object, book. Other than for purposes of reducing confusion (of which there is a good deal in the English language), there is no particular reason to prefer one word symbol over another, as representations of the same object.

Outside of their general use as language, words may acquire almost a universal symbolism. The conventional "STOP" sign is essentially a word symbol in many languages, reinforced by its being pointed on a red, octagonal sign. In New York, Chase Manhattan Bank has spent a great deal of money to popularize a simple geometric symbol. First National City Bank, however, abandoned a rather complex symbolic representation of the globe and is, instead, using its new official name, Citibank, as a word symbol.

Language or written symbols need not be confined to one word. The conventional disclaimer that identifies a preliminary prospectus as a "red herring" is five lines of small print. The symbolic content of the message is undoubtedly enhanced by the use of red ink, but it remains essentially a series of words. Once a novice investor discovers that the words are identical on every red herring, one doubts that the message is ever read again. The symbol makes the point.

Written symbols need not be confined to relatively short messages. The Declaration of Independence (about 1,400 words) is the most important of all American historical documents. It is essentially a partisan document; a justification for the American revolution. Yet, its unique combination of general principles and abstract theory of government coupled with a specific enumeration of the conditions of freedom have made it one of the great Western political documents. Query, does the viewer of a framed reproduction of the original parchment on a wall review all these complexities? Of course not; it is but a symbol of American democracy, and whatever democracy means to that viewer.

As with so many symbols, the accuracy of representation and interpretation is not always perfectly clear. We celebrate July 4, the date on that document, as the symbol of Independence Day; the resolution itself was voted on July 2. It was not signed until several days later; no signatures were applied on the 4th. Far more important, of course, is the degree of comprehension of the philosophical content. It is apparent that the Declaration was viewed as almost officially binding

for some time; the Constitution of the United States and of many individual states clearly reflect the social contract it specified.

Today, its influence and clarity may be somewhat different. Although reproductions on the wall are honored, we are all familiar with occasional stories in the press of how enterprising "inquiring reporters" are unable to convince unsuspecting people to sign or endorse verbatim extracts from the Declaration of Independence.

Interpreting Symbols

Clearly, this long and detailed English language document has become a symbol whose actual original content is not known to many who pay it homage. Only at certain critical or celebrated times do people seem to refer back to the original symbol. Thus Watergate and the bicentennial celebration appear to have produced a good deal of rereading of two key symbols, the Declaration of Independence and the Constitution.

Sometimes rereading or reexamination may lead to "agonizing reappraisal." Arthur Schlesinger, for example, in *The Imperial Presidency* confesses to current disenchantment with that former symbol of (modern) liberal dogma, the strong presidency. Thus, the same symbol may have different meanings to the same person, at different times, as experience tempers interpretation.

A symbol need not have a tangible existence or even be visible in any way. As Fromm noted, man constantly engages in *actions* which are essentially symbolic, from the simple removing a hat as a symbol of respect for a woman, to shaking hands as a symbol of friendly feelings, to the biblical rending of garments as a sign of mourning.[8]

Of course, the Freudians consider dreams as symbols; complex symbols that require intense probing to determine their real meaning. However, the concept of a dream as a symbol, albeit interesting, leads to aspects that are not particularly fruitful in this discussion, for we are interested in the symbol as a vehicle for communication *between* people, not for the self revelation of one person.

Herman Wouk points out the extraordinary complexity of the Old Testament symbol of Sabbath observance.[9] The Sabbath strictures against work appear, at least superficially, as merely a rigorous means of enforcing a day of healthy rest for overworked farmers and merchants, seemingly reflecting the biblical rest of the Lord. However, the Sabbath observance rules prohibiting work are not to be interpreted literally. Indeed, in many cases the "work" required to obtain the literal rest of the Sabbath may exceed any concept of leisure and relaxation. However, the biblical concept of work is any interference by man, be it constructive or destructive, with the physical world. "Rest" is a state of peace between man and nature. Thus, reading of the scripture, which is "work" in a modern sense, is the "rest" of the sabbath, since it helps to achieve a state of peace between man and his God. The symbol "the Sabbath" may be interpreted on one level by orthodox intellectuals such as Wouk, and on a much lower, virtually automatic level, by ordinary believers, who simply light the candles, etc. at the right hour.

Is the Auditor's Report a Symbol?

Unfortunately, not a great deal is known about the way or ways in which

investors, creditors and others use the auditor's report, nor about the message(s) they derive from it.

One starting place for consideration of the nature of the auditor's report is the reader of this paper. It is likely that the readers of this work will consist of persons reasonably familiar with annual financial statements and auditors' reports; indeed most are habitual readers of annual reports.

Undoubtedly, during the course of reading an annual report (hopefully early in the reading) you examine the auditor's opinion. Now, consider just how you examine the auditor's opinion. Do you read every word, savoring each carefully constructed phrase until the full flavor of the delicious prose of the one or two paragraphs is clearly communicated? Of course not! You glance quickly, measuring length and shape, at the same time noting the *absence* of several possible phrases such as, "except for" or "subject to." Probably one positive, searching element of your scrutiny will be absorbing the name of the auditing firm affixed to the report.

Assuming that the troubling phrases are not detected and that the firm name does not connote any extreme reaction, you, as one of the better educated readers of financial statements, may then be completely finished with the auditor's report. Hundreds of thousands, possibly millions of dollars have been spent to obtain that report, and you complete your viewing in seconds.

Was your speed of viewing due to any distaste for the wording, or to a belief that the report was unimportant? You will undoubtedly spend many multiples of the time devoted to the audit report on the notes to the financial statements; are they that much more important?

The answer, of course, is obvious. You know the words in the auditor's report; indeed, if you are a practitioner or a teacher of accounting you probably know them by heart. You also know what you believe the words mean, although some searching would demonstrate that there are wide variations in the perceptions of that meaning, even among "experts." Only if the auditor's report looks "different"—that is, if it contains an exception, will you devote any significant time to studying it. The auditor's report, at least in its most common form of a clean opinion, is a symbol.

Unfortunately, such little exercises in personal exploration do not make the stuff of solid research conclusions. And equally unfortunately, there has been little formal research devoted to careful study of user perceptions of the auditor's report.

Researching the Audit Report

An elaborate opinion research study conducted for Arthur Andersen & Co. inexplicably focused comparatively little attention on the auditor's report. One question did indicate that approximately half of all shareholders read the auditor's report most or all of the time. The other half indicated that they sometimes, rarely, or never read the auditor's report.[10] The Andersen publication also contained a series of individual responses received in reply to the query, "What in particular do you look for in the auditor's report?"[11] The number of responses reproduced is too small to permit any real analysis, but they do appear to be divided about equally between those who:

1. Were not clear what the auditor's report is (for example, versus the financial statements).
2. Looked only to see if there were exceptions in the report.

Respondents who had indicated that they rarely or never read the auditor's report were asked for their reasons. Virtually all the responses indicated ignorance of what the survey meant by the term "auditor's report."[12] While this would be the expected response, explanations of reasons for negative action or inaction are rarely meaningful or useful. On the other hand, those who responded that they were only searching for exceptions would appear to be following the same symbol reading process that was described above.

Marc Epstein's study on shareholder views of the annual report provided somewhat more interesting data.[13] His study contains several unpleasant conclusions. Perhaps most upsetting was the indication that the annual report, the repository of the auditors report, was quite low on the scale of information sources preferred by investors. Almost half of the respondents considered "Broker's advice" to be the most preferred source of information. If broker's advice as a source is combined with those who indicated investment service and financial periodicals, fully 85% of the recipients preferred the use of a completely secondary source. Only 15% indicated the annual report as a preferred information source.[14]

An additional 10% of the respondents indicated that they used "technical analysis." The use of this term was unfortunate, since it carries two different and quite contradictory meanings. To some it may connote conventional techniques of financial analysis. However, to many others, it undoubtedly means one or more of the chartist approaches, such as the Dow theory, which are in direct opposition to financial analysis.

Attempts to draw strong conclusions from Epstein's results must consider the substantial proportion of his respondents who were unconcerned with the annual report, and hence, may be presumed to have no valid position (other than apathy) regarding the auditor's report.

Nevertheless with this caveat, and helped by the reasonably large sample, some insight may be gained.

On questions related to the reading and usage of the auditor's report, Epstein's respondents gave results which he correctly labeled as "paradoxical."[15] Relative to investment decisions, the auditor's report ranked lowest in "usefulness" (p. 41), compared to all other parts of the annual report, including the "president's letter." The auditor's report also ranked lowest in "thorough" readership, as compared to all other parts of the annual report (p. 40). In a comparison of the responses of sophisticated and unsophisticated users of financial statements, the utility of the auditor's report was about the same to both groups (p. 52).

Epstein attempted to derive a relationship between readership of an item and its apparent utility to the reader. For the auditor's report, the results were again "paradoxical."

> . . . while the probability is close to one-half that a cursory reading (of the auditor's report) would be just as useful as a thorough one, the odds are 8 to 1 that a thorough reading would yield more useful information than a cursory one in the other 50% of the cases. (p. 46)

The confusion was compounded by an indication that most respondents did *not* want additional information or explanation about the auditor's report.

Epstein's results are indeed somewhat confusing, *if* the auditor's report is considered as an element of the annual report which contains what might be called "variable" information; that is, if the auditor's report contains information that would often be new and different when read by a user.

However, if the auditor's report is a symbol to the reader, then Epstein's results are quite logical. Most viewers of symbols do not read them at length; they glance at them. This explains the low readership. However, if the symbol is unambiguous and easily comprehended, all readers should be able to gain the desired information in the same brief glance. Hence the similarity of apparent utility to sophisticated and unsophisticated investors; both get the same message quickly and easily. But, what about the supposed low utility of the auditor's report to both groups? Consider the symbol referred to earlier of a reproduction of the Declaration of Independence on the wall of an office or school room. Does that symbol—the reproduction—have any great utility? No. It is the concept, the existence of the democratic institutions underlying the Declaration of Independence that gives value and symbolism to the reproduction. The reproduction itself is of no importance, other than a reminder of the existence of the reality.

The auditor's opinion is also only a reminder of the fact that an audit was performed. If the opinion is "clean," the audit itself is largely irrelevant to the reader, at least as far as investment decisions are concerned. Thus, the clean opinion has little apparent utility in investment *decisions*, so long as it is there. Unfortunately, Epstein did not (and probably could not) test the utility of the audit report against the situation where the audit report was not there; that is, the utility of audited financial statements versus unaudited statements.

Note too, that the symbolic concept also explains the results quoted above: that in one-half of the cases, a cursory reading is as valuable as a thorough one, and that in the other half of the cases, a thorough reading might carry much more value. Epstein did not distinguish between clean and qualified opinions. One can easily hypothesize that a clean opinion yields the same information in any type of reading, while the opinion with exception provides more information to the thorough reader.

In sum, portions of the paradoxes suggested by Epstein could be explained if the auditor's report *is* perceived to be a symbol by most readers.

If the Auditor's Report Is a Symbol

There appears to be reasonable evidence, along with common sense perception, that many readers of many auditors' opinions do, indeed, regard the report essentially in the nature of a symbol. If the opinion is a symbol, what then are the implications for the communication problem?

One obvious consideration would involve a determination of the message, or messages now being drawn by users from the symbol. As we noted earlier, the same symbol may well produce substantially different messages to different viewers. For the seasoned auditor, the "clean opinion" probably conjures up a variety of images, possibly varying depending on personal experiences with clients. An auditor whose experience has been limited to "clean" audits may well perceive

the opinion in the light of these pleasant jobs. An auditor with a more varied client base may well be reminded of less than satisfactory resolutions of difficult problems. By imputing personal experiences to auditors' reports in general, the view might be quite skeptical.

Auditors, of course, constitute only a small fraction of the total audience for auditors' reports; the reactions of investors and creditors are of far greater interest and importance. Unfortunately, as suggested by the earlier discussions, little is known about the messages received by users of audited financial statements. The comments given by respondents to the Epstein study suggest that at least some investors—with no apparent distinction between sophisticated and non-sophisticated—seem to view the clean opinion as a "Good Housekeeping Seal."

Given the lack of information about the symbolic message(s) users received from the auditor's report, there appears to be little value in additional guessing in this area. Clearly, however, research to determine the nature of the message(s) received by users should have high priority.

For purposes of this paper, let us hypothesize that users of audited financial statements do receive a message from (clean) opinions that is essentially a seal of approval. Let us also hypothesize that it is agreed that users ought to receive some other message, not merely one which connotes "approval." This hypothesis begs the very real question of whether or not a simple message of "approval" is the appropriate information that should be derived from the auditor's report. Mautz and Sharaf suggest an audit report that states:

> We have examined with due audit care the data found in (name of statement or statements) and find that they present fairly (the purpose of the statement).[16]

Thus, they appear to be sanctioning just such a message. Nevertheless, let us assume that it is desired that the auditor's report carry some other message than the one(s) presently conveyed to users.

Small Changes in a Symbol Are Useless

A great deal of effort has been expended by members of the accounting profession in devising rather minute changes in the wording of the standard form opinion. The differences between the usage of "presents fairly" and "true and correct" (by the British) produced many articles and an almost fundamental schism between the U.S. and the British professions. Today, the accounting profession continues to consider small changes in the wording of the report.

A basic point in symbol perception is that small differences in complex symbols are not readily perceived. Slight modifications in the wording of the opinion, although possibly perceived to be of great import to the accounting profession, are likely to go unperceived by users of auditors' reports.

It is possible that a small difference in the wording of the opinion would have an effect in a court case, but it is doubtful. While accountants and others are fond of ridiculing the lawyers' preoccupation with fine differences of wording, there appear to be few, if any, court cases where the decision has hung on a few words in the opinion. On the other hand, there are many court cases where the total (symbolic) impression created by the opinion was the central focus.

Thus, the first conclusion to be drawn, if the auditor's report is a symbol, is that small wording changes in the opinion are probably futile exercises. The opinion will be viewed as a whole, as a symbol. Slight changes in the symbol will not be noticed, examined, or internalized by users.

It follows, then, that any changes in the auditor's opinion to be meaningful should be significant changes, both in substance and in *form*. The user of the report must quickly perceive that a different symbol is present. That perception will be necessary to force a further investigation of the new symbol.

Is Education the Answer?

A related conclusion concerns efforts at "education" of the users of financial statements. It has frequently been asserted that since the user of the auditor's report does not appear to understand what the report connotes, the user must be educated. A number of persons appearing before the Commission on Auditors' Responsibilities suggested the development of a booklet or other device that would inform users about the meaning of the auditor's report.

While such educational efforts would probably not be harmful, their effectiveness, alone, is doubtful. First, there is now no shortage of auditing textbooks that clearly explain what auditors do. More important, however, is that in the absence of a significant change in the symbol—the auditor's report—the educational effort will most likely be wasted. Users already have perceptions of the meaning of the symbol. It is extremely difficult to *explain* to them that the symbol means something else. Indeed, it is much easier to change the symbol, for a new symbol will be perceived as potentially meaning something else.

Note that business organizations have grasped that concept. When corporations attempt to change their "image," they inevitably change the visual symbol, sometimes even the name of the corporation, in order to produce a quickly understood message. It is apparently of little use merely to "explain" that there has been a change; a symbolic indication appears necessary.

Thus, any intended changes in the meaning of the auditor's report should be accompanied by a clearly visible change in the size, form or other make-up of the report.

This conclusion suggests a corollary with regard to opinions with exceptions. Since it seems clear that readers regard the clean opinion as a symbol, efforts should be made to assure that the different symbol, namely an opinion with an exception, can be noted quickly and easily. This again suggests some substantial difference in form, rather than a small wording change, to indicate an exception. This difference could be accomplished in several ways. All clean opinions could be written in single paragraph form, with a two or three paragraph form used for opinions with exceptions. Alternatively, or in addition, the entire exception could be included in the opinion, rather than as is currently common, by making a brief reference to a footnote that describes the exception in detail.

Symbols Can Carry Simple or Complex Messages

As noted early in this paper, there appears to be a persistent tendency among auditors to shorten the conventional standard form opinion. There are obviously

several reasons for this tendency, one of which is the probably misguided belief that a shorter opinion reduces potential legal problems.

Another element of the tendency towards brevity, however, appears to be the feeling that the opinion cannot be made to carry a complex message. Stated another way, the current readership of the opinion appears to be cursory (as explained above). Therefore, if a longer explanation of the auditing process were included in the opinion, it too would not be read.

If the lack of interest of readers of the present short-form report were due to a general lack of interest in the audit and the audit report, then the previous logic would indeed follow. However, as has been suggested earlier, it is more logical to suppose that users do not now read the short form report because they do not have to; it is a symbol and they think they understand it without reading it again and again.

It was earlier noted, however, that symbols need not be brief or simple in meaning. Some symbols convey simple messages; some convey complex messages, and *some convey both simple and complex messages, depending upon the reader.* There is no logical reason for believing that the auditor's report cannot be made to convey a complex message. In addition, it might be possible to convey, at the same time, a simpler message.

Consider, for example, the possibility of substantially enlarging the current short form opinion to include a brief description of the principal assumptions of auditing—testing, sampling, evidentiary limitations, etc.—along with a brief summary of the principal audit steps. Certainly, some of the present beliefs by many users (as expressed in many court cases) in the apparent infallibility of auditors and the audit process (and even the accounting process) might be dispelled.

Would users read such an expanded version of the audit report? Epstein's study seems to suggest that users read that part of the annual report that they believe contains new or variable information. If the opinion were substantially expanded, readers would find a new symbol. It seems logical that if the new symbol appeared sufficiently different from the old, then users would be virtually forced to attempt to understand the new symbol. That process would involve a reading of the new, long report and attempts to comprehend its meaning and import.

Assuming that such comprehension were eventually achieved, through either repeat reading or other sources, the new, longer report would once again become another (usually) unread symbol. But, the message of the symbol would have been changed and presumably understood (or misunderstood) by users.

Note, that this analysis also suggests the possibility of "two tier" disclosure, which has been advocated frequently by the SEC. The longer audit report could well convey one important message to certain readers, such as the courts, while at the same time, it could provide a simpler message of approval to the ordinary investor.

The key point, however, is that if the opinion is a symbol it does not follow that it must be simple or brief. To the contrary, a symbolic interpretation suggests substantially greater possibilities for complexity.

Of course, the concept of the report as a symbol could also be used to support a shortening of the current, standard form report. As cited above, Mautz and Sharaf suggested a shorter form. However, if the clean opinion is only a symbol

of approval, then, in its simplest and most readily comprehended form, it might merely state:[17]

CLEAN OPINION

Footnotes

1. Arthur Andersen & Co., *Annual Report to Our World Wide Organization,* August 31, 1975, "Report of the Public Review Board," p. 4. This information was apparently given in an attempt to provide disclosure of customer information comparable to that demanded of public companies by the Securities and Exchange Commission.
2. The guess as to the largest AA client is based on a comparison of firm clients with the Fortune 500 list. It is possible that the many troubles of Mattel, Inc., another but considerably smaller AA client, could have resulted in an unusually large audit fee. Other very large AA clients are Tenneco and Kraftco.
3. Three of the opinions (UAL, ITT and GT&E) were "clean." Texaco's opinion included an exception for a change from FIFO to LIFO, while that of Occidental Petroleum included mention of changes in accounting for inventory and research and development expenditures.
4. From George Cochrane, "The Auditor's Report: Its Evolution in the U.S.A.," *The Accountant,* November 4, 1950, pp. 448-460.
5. D. R. Carmichael, *The Auditor's Reporting Obligation,* American Institute of Certified Public Accountants, 1972, pp. 13-14.
6. *Encyclopedia Britannica,* 11th ed. (1911), Vol. XXVI, p. 284.
7. Erich Fromm, *The Forgotten Language,* Grove Press, New York, 1951, p. 12.
8. *Ibid.,* p. 242.
9. Herman Wouk, *This is My God,* Doubleday, 1959.
10. Arthur Andersen & Co., *Public Accounting in Transition,* 1974, p. 38.
11. *Ibid.,* p. 192.
12. *Ibid.,* p. 193.
13. Marc Epstein, *The Usefulness of Annual Reports to Corporate Shareholders,* California State University, Los Angeles, 1975.
14. *Ibid.,* p. 34.
15. *Ibid.,* p. 46.
16. R. K. Mautz and Hussein Sharaf, *The Philosophy of Auditing,* American Accounting Association, 1961, p. 203.
17. As suggested by Lynn Seidler, the writer's wife and co-author.

Discussant's Response to Symbolism and Communication in the Auditor's Report

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Professor Seidler's analysis of symbolism as a major factor in the auditor's report is most perceptive. Intuitively, I have felt for some time that the standard wording of the audit report should be retained. However, the arguments that the auditor's report should be expanded or contracted, clarified, simplified, or whatever it was felt was necessary to improve communication also sounded reasonable. The concept of the audit report as a symbol resolves my dilemma.

Changes in the Wording of the Auditor's Report to Improve the Symbol

It is a fact that the standard wording of the auditor's report has been adopted, utilized and well recognized. Except for those trained in accounting, who understand the overall scope of the examination and the background and meaning of the terms "auditing standards," "accounting principles," and "opinion," the only way to understand the general use and acceptance of the audit report is as a symbol.

Upon reflection, as Professor Seidler points out, even those who have the background and knowledge to understand the technical meaning of the words do not concern themselves with the standard words, but rather look only for the exceptions. The standard wording is a symbol also for the technicians.

It becomes quite clear, then, that changing a few words or adding explanatory comments in the standard audit report are not the answer for improving communication in the auditor's report.

The communication problem results from the fact that the same symbol may carry different messages to different viewers. For example, certain users of the audit report interpret it as a guarantee rather than an expression of opinion as to overall fairness of the presentation of the financial statements. Some may argue that an explicit statement such as "This is not a guarantee as to the value of the assets included in the financial statements" would improve the communication. But even this explanatory comment could convey different messages to different readers. Knowledgeable readers would say "Of course the auditor is not a guarantor." But others could interpret such a comment as an adverse statement.

Nor would listing the auditing standards or the detailed procedures followed in the audit necessarily increase the effective communication for most users. As indicated by the studies to which Professor Seidler referred, ". . . most respondents did *not* want additional information or explanation about the auditor's report." Moreover, the listings would tend to become repetitious, and users looking for a symbol of credibility would be concerned only with any exceptions. This has

already been demonstrated historically with the decline in the use of the auditor's long form report. The concepts embodied in the phrases "generally accepted auditing standards" and "the procedures necessary in the circumstances" convey the message adequately.

Psychological Impact of the Auditor's Report

If one accepts the proposition that the audit report is a symbol and changes in wording will have little or no effect on improving the communication between issuers and users of the report, this still leaves the question as to what message the symbol should convey. The issuer, in general, wants to indicate the scope of the examination, that the examination has been made in accordance with generally accepted auditing standards, that tests of the accounting records and other audit procedures were those considered necessary in the circumstances, and that the opinion attests to the fairness (in accordance with generally accepted accounting principles) of the financial statements that were examined. The issuer also wants the message to indicate that generally accepted accounting principles have been consistently observed in the current period in relation to the preceding period, that the informative disclosures are reasonably adequate, and that the degree of responsibility being taken is clearly shown.

The reference to "generally accepted auditing standards" connotes the entire professional background of the auditor and the methodology of conducting an audit which takes years of education and experience to acquire and adequately comprehend. The issuer of the reports uses the standard wording to convey this message. Consciously or sub-consciously the issuer must recognize that the words used are only a symbol for the message intended to be conveyed. The psychological impact of the issuer's background and training make it possible for the issuer to be satisfied that the message is being conveyed.

While some critics of the report may be dissatisfied with the adequacy of the message, the consensus is certainly that a message is being conveyed. This consensus may be even more pervasive if the audit report is recognizd as a symbol.

The psychological impact of the symbol to the user of the report would seem to be even more evident. Seidler makes the point well when he says, ". . . if users do perceive the auditor's report largely as a symbol, then it can be used to convey the highly complex message that must inevitably result from the previously described enormous labors of the auditors." In any event the psychological impact both for the issuer and the user of the audit report is reflected in the fact that the independent auditor's attestation to the credibility of financial statements is generally accepted.

Some Limitations to the Symbol Concept

If all opinions were unqualified, the basic hypothesis that the auditor's report is a symbol would be even more meaningful. However, the fact that there are qualified opinions, disclaimers, and adverse opinions gives rise to degrees of credibility. When there is a modification of the standard wording due to a qualification of the auditor's report, it then becomes important to read the auditor's report carefully. Further, various types of "special reports" require careful reading, since the standard wording and, accordingly, the basic symbol are not applicable.

One cannot dispute Seidler's observation that ". . . if the opinion is 'clean,' the audit itself is largely irrelevant to the reader, at least as far as investment decisions are concerned. Thus, the clean opinion has little apparent utility in investment *decisions*, so long as it is there." But that is the main point—SO LONG AS IT IS THERE. Other audit reports such as qualified opinions, disclaimers of opinions related to unaudited financial statements, and "special reports" cannot be classified as covered by the basic symbol. Accordingly, the basic symbol concept can be utilized only for "clean" opinions.

It is quite evident that minor changes in the wording in the basic symbol (the clean opinion) will not be effective. No matter how important such wording changes are to the auditor who prepares the report, they will probably have little or no effect on the user. Accordingly, if the intention is to utilize a different symbol (e.g., an opinion with an exception), then an overt effort must be made to distinguish between the basic symbol and a new symbol. Seidler makes it clear that the new symbol must be significantly different in both *substance* and *form.*

This can be implemented, for example, if a Statement on Auditing Standards were issued which would require that all unqualified (clean) opinions be written in a single paragraph, whereas qualified opinions, adverse opinions, disclaimers of opinion or "special reports" must be in a format of two or more paragraphs. These "one:two" symbols would be more readily differentiated than today's "two:three" symbols.

While one can concur, substantially, with the thesis that the standard short form report is a basic symbol, it is not necessary to agree with the idea that the symbol can be reduced to just the two words, "Clean Opinion." As indicated earlier, especially from the viewpoint of the preparer of the audit report, there is merit in stating the scope of the examination and repeating in each report the reference to "generally accepted auditing standards," "generally accepted accounting principles," "fair presentation," and "consistency."

The Impact of the Symbol on the Issuer of Financial Statements

In his presentation, Professor Seidler refers primarily to the communication between the auditor and the third party user of the financial statements. In discussing communication as related to the auditor's report, it is also appropriate to recognize the communication involved between auditor and client (the issuer of the underlying financial statements). While much of this communication is conducted through other media (e.g., the "letter to management"), the psychological impact of the "clean opinion" symbol on the issuer of the financial statements should not be overlooked. It is important to the issuer of the financial statements (the client) to have an auditor's report symbolic of a "seal of approval." Accordingly, the client will adapt recording procedures, presentation, valuation of assets or liabilities, or disclosures in order to receive an unqualified opinion.

Some Considerations Related to the Future

Accepting the hypothesis that the present standard short form unqualified auditor's report is a symbol, does not, as Seidler recognizes, solve the massive communication problem that currently faces the auditor. The search for a solution of that overall problem is left to the Commission on Auditors' Responsibilities.

Even as the Commission grapples with the problem, the complications increase. Auditors are now called upon to report on interim financial statements and footnotes related to "replacements costs," neither of which is encompassed by the basic symbol. Moreover, the future portends new types of disclosures and the reporting and attestation to many new types of information. For example, reporting on such matters as forecasts, systems quality, and social accounting information will not only require considerably more knowledge and skill for the auditor, but will also have a significant impact on communication and the nature or types of symbols that can or should be used.

Auditors functioning as reviewers of and attestors to new types of information will undoubtedly face great obstacles in attempting to communicate with users. The new information will reflect many unfamiliar concepts, judgments and imprecisions. Moreover, much of the new data will be more subjective and less quantifiable than the data underlying current financial statements.

In summary, the recognition of the auditor's report as a symbol is significant in giving an important perspective to the communication between the auditor and the users of the audit report. But the overall solution of the auditor's communication problems—both in the present and in the future—leaves a fertile field for exploration, research and analyses by auditors, researchers and educators.

4

Risk and Uncertainty in Financial Reporting and the Auditor's Role

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Grant's Is Going Out of Business

Just as the newspaper, radio and TV ads say, this is an honest-to-goodness closeout sale. W. T. Grant Company, one of the nation's major retailers, has filed for bankruptcy.

Predictably—and it's one of the few accurate predictions possible when a company declares bankruptcy—everyone involved in the issuance of the financial statements, including the independent auditors, has been named in a class action suit alleging past financial statements were false and misleading. Such events raise a critical question: What is the auditor's obligation to warn investors of impending trouble?

A Look at the 1974 Annual Report

The untutored eye of the ordinary investor only had to be open to see W. T. Grant was in trouble. In his opening message to stockholders, James G. Kendrick, Chairman of the Board and President, outlined ". . . the three most serious problems facing the Company:

- A serious merchandise imbalance.
- The severe burden posed by the accelerated store expansion program.
- The excessive build-up of credit receivables, financed at high interest rates and administered through an exceedingly expensive credit program."

For the year ended January 30, 1975, sales dropped slightly, but $24 million was charged for store closing expense, net credit expense went from approximately $6 million to $161 million, and earnings showed a loss of nearly $177 million, after having declined to $11 million for the year before. Short-term debt had increased steadily over the last five years to $600 million. The current ratio dropped from a range of 1.5 to 1.7 in past years to 1.2. Dividends per share of common stock were cut from $1.50 in prior years to 30¢.

All that information was spelled out in detail for investors. Anyone who continued through the annual report to the notes to financial statements found more

* This paper presents the author's personal views and is not necessarily representative of the views of any AICPA Committee, the Commission on Auditors' Responsibilities, or other AICPA or Commission staff members.

distressing news. Changes in the company's borrowing agreements revealed creditors and suppliers of merchandise were very concerned with Grant's ability to pay.

The Auditors Were Uncertain

Grant's independent auditors issued the following "subject to" qualified opinion dated April 18, 1975.

> We have examined the consolidated statements of financial position of W. T. Grant Company and consolidated subsidiaries as of January 30, 1975, and January 31, 1974, and the related consolidated statements of operations, capital and changes in financial position for the 52 weeks ended January 30, 1975 and the year ended January 31, 1974. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The financial statements of Zeller's Limited, used as the basis for recording the Company's equity in net earnings of that corporation, were examined by other independent accountants whose reports were furnished to us. Our opinion expressed herein, insofar as it relates to the amounts of net earnings included for Zeller's Limited, is based solely on the reports of the other independent accountants.
>
> As discussed in Note 10 to the financial statements, the Company has protested certain deficiencies in consolidated Federal income taxes proposed by the Internal Revenue Service for the years ended January 31, 1964 through 1971, and is presently in litigation regarding such proposed deficiencies for the years ended January 31, 1964 and 1965. It is not practicable to estimate the additional income taxes and interest payable, if any, at this time. As discussed in Note 2 to financial statements, the continuing value of the Company's total investment in the common stock and convertible notes of Granjewel Jewelers & Distributors, Inc., a 51% owned subsidiary, may be impaired as a result of the potential inability of such subsidiary to continue as a going concern.
>
> In our opinion, based on our examinations and the reports of other independent accountants, subject to the effects, if any, on the financial statements of the ultimate resolution of the matters discussed in the preceding paragraph, the financial statements referred to above present fairly the consolidated financial position of W. T. Grant Company and consolidated subsidiaries at January 30, 1975 and January 31, 1974, and the consolidated results of their operations and the changes in their financial position for the 52 weeks ended January 30, 1975 and the year ended January 31, 1974, in conformity with generally accepted accounting principles applied on a consistent basis after restatement for the change, with which we concur, in the method of accounting for finance income as described in Note 1 to the financial statements.

What Is the Purpose of the "Subject to" Qualification?

Is the auditor pointing to something that is wrong with the financial statements? The answer has to be "no" because then the report would indicate a

departure from generally accepted accounting principles and the qualification would be introduced by "except for."

Is the auditor only emphasizing a matter that is already apparent from or disclosed in the financial statements? Note 2 discloses that ". . . because of the net loss incurred by Granjewel and difficulties in obtaining adequate financing sufficient for continued business operations and compliance with terms of loan agreements, it is not presently determinable as to whether such subsidiary will be able to continue as a going concern." The dispute with the IRS is also fully explained in a note.

Should the "subject to" qualification be viewed as a withholding of an opinion on a portion of the financial statements that is indeterminable because of the uncertainty? Does the qualification, therefore, indicate a possible future adjustment of that portion of the statements?

Perhaps the function of the "subject to" qualification is only to post a warning of impending trouble. If that is its purpose, how serious or imminent should the matter be before qualification is required? Should investors have expected the auditor's report to point to the information in the annual report that showed W. T. Grant Company might not continue in existence? Certainly that possibility should have been apparent to the investor from a quick reading of the annual report. But why then is any qualification necessary?

The auditor's reporting obligation for significant or unusual uncertainties is far from settled. The answer ultimately depends on the view taken of the independent auditor's role. The auditor's role is to add credibility to financial information. The auditor cannot change the risk of doing business. Neither is it possible to guarantee the success of the businesses that are audited. One important facet of the free enterprise system is that every business has the opportunity to fail.

Information Risk vs. Business Risk

Two distinct types of risk accompany investment in securities.[1] Information risk is the risk associated with production and distribution of financial information. It represents the possibility that the same business conditions will appear to be different because of errors in the process of accumulating, summarizing, or presenting information. Reducing information risk is the auditor's job.

Business risk represents the forces in an uncertain economy. Success in business requires taking chances. Big success requires huge gambles. Investors who want to share in the possibility of success assume the risk that naturally accompanies the uncertainties inherent in business activities.

How Do Uncertainties Affect the Auditor's Concern with Information Risk?

The auditor's responsibilities for reporting on financial statements are covered in the AICPA's Statements on Auditing Standards. Statement on Auditing Standards No. 2 advises independent auditors that ". . . when there are material uncertainties the outcome of which is not susceptible of reasonable estimation, the auditor should consider whether to express an unqualified opinion or to qualify his opinion. . ." An opinion qualified because of an uncertainty takes the general form of the auditor's report on W. T. Grant's financial statements. The form of

an auditor's qualified opinion is spelled out in detail, but the meaning and significance of a "subject to" qualification and what should require it are still debated by accountants.

For example, Henry Hill recently expressed the view that "the proper method of reporting on uncertainties seems to be the greatest uncertainty of all."[2] Louis H. Rappaport has described the major point of contention in these words:

> Some accountants contend that the "subject to" qualification . . . is redundant and unnecessary. In most cases where it is used, there is a clear reference to information in the statements, indicating that the matter cannot be resolved. A lawsuit, for example, is awaiting judicial determination, and counsel is unable or unwilling to forecast the result. An important tax case is awaiting decision in the Tax Court. A company's claim for reasonable profits on government contracts is before the Renegotiation Board. A company's basic patents are being challenged by competitors. A company's application for rate increases is being heard by a regulatory commission having jurisdiction over rates. Where these or similar circumstances exist, in all likelihood they are set forth in the financial statements or in notes to the statements. Since the statements with their notes do set forth the company's financial position and results of operations, what good purpose is served by the "subject to" language in the accountants' certificate calling attention to what is in the statements? These accountants contend that qualifications and exceptions should be restricted to those matters with respect to which there is a disagreement between the accountant and his client. In the circumstances which we have been discussing there is no dispute; the accountant presumably is completely in agreement with the representations in the statements.
>
> Other accountants, however, contend that in these circumstances the company's financial position and/or results of operations are indeterminate and they are therefore not in a position to form an opinion in respect of the matter in question. For that reason, and for reasons of emphasis, they believe the "subject to" qualification is appropriate.[3]

The debate on "subject to" qualifications has been going on for some time. Some accountants have the impression that proper use of "subject to" qualifications was settled long ago. Actually, an accounting series release by the SEC as recently as 1962 set the present ground rules and caused the "subject to" qualification to assume its current significance. Independent auditors had recognized the possible need to qualify opinions in the early 1900's and the "subject to" phrase was one of the earliest used. However, as late as the 1950's the phrases "subject to" and "except for" were used interchangeably.

In Accounting Series Release No. 90, the SEC specified the following distinction:

> A "subject to" or "except for" opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The "subject to" qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date.

Shortly after ASR No. 90 was issued, one accountant observed:

> It has been our opinion for many years, dating back to pre-SEC days, that the words "subject to" in an opinion paragraph were so ambiguous that they conveyed no clear-cut meaning to the reader. There is no way of telling whether they are intended to be a qualification of the opinion, or whether they are intended merely to direct the attention of the reader to some significant fact which has been more fully disclosed elsewhere.[4]

A newcomer to the financial reporting scene might reasonably wonder what all of the fuss is about. What difference does it make if auditors' opinions are qualified and, if they are qualified, why does use of "subject to" rather than "except for" make any difference?

The Importance of Being Uncertain

For one, the SEC is very concerned with the form and content of the auditor's report. Under the administrative procedures followed by the SEC staff, the type of auditor's report has important consequences. Generally, financial statements will not be acceptable in a filing if the auditor is unable to express an unqualified opinion because of a departure from generally accepted accounting principles or a limitation on the scope of the examination. On the other hand, a qualification caused by an uncertainty is not automatically unacceptable.

In practice, the "subject to" qualification has become an administrative convenience. Since it is relatively easy to recognize that a qualification is introduced by "subject to" rather than "except for," the "subject to" phrase has become the password for an acceptable qualified opinion. Thus, one of the problems caused by the "subject to" qualification is that since it is acceptable to the SEC, any matter that can possibly be regarded as an uncertainty may receive a "subject to" rather than an "except for" qualified opinion.

A "subject to" qualified opinion, however, may not be so acceptable to investors. In its 1972 annual report, Boothe Computer showed a $36.5 million write-off of additional depreciation on its portfolio of IBM 360 equipment. Commenting on Boothe's annual report, *Forbes* magazine described a "subject to" qualification in this exuberant language:

> Now we read that even with the decks thus cleared, Boothe's auditing firm, Touche Ross & Co., had still qualified its opinion of the company's 1972 statements. A qualified opinion is no laughing matter. It's like tacking a quarantine notice up on a company's door. Bankers, creditors, beware! Bondholders, stockholders, on your guard! Touche Ross was saying that even with the carrying value of Boothe's rental equipment pared way, way down by the write-off, it still had serious reservations about the company's ability to recover the remainder of its computer investment through future rentals.[5]

Thus, a "subject to" qualified opinion has several consequences. In comparison to other types of qualifications, the company's financial statements are acceptable to the SEC, but investors are warned reported results may at some future date be adjusted. Also, the general belief has been that by pointing out the uncertainty the auditor will be absolved of responsibility if the uncertainty is resolved unfavorably.

The influence of a "subject to" qualification makes resolution of questions concerning its meaning or its necessity important. What are the relationships among the auditor's opinion, the uncertainty, and the financial statements? Is the opinion or the financial statements "subject to" the uncertain outcome? What purpose is the "subject to" qualified opinion intended to serve and does it do so effectively?

Forbes' consideration of Boothe's 1972 annual report, for example, points out that two other computer leasing clients of the same public accounting firm received clean opinions that year. Both Leasco Corporation's leasing subsidiary and Greyhound's subsidiary, Greyhound Computer Corporation, are in the same business as Boothe. All three companies had similar-sized rental portfolios in the $200 million plus range and all were facing the same competitive problem of IBM's new 370 computer line. *Forbes* expressed the following conclusion on the merits of "subject to" qualifications:

> As for us, we could only conclude that Touche Ross would have done us all a greater service if it had explained in more specific detail exactly what it was that it was certifying—that all three companies face significant uncertainties, but that in its opinion Boothe's uncertainties are more significant. Shareholders would not assume, as they may have by the absence of write-offs and dirty opinions, that Leasco and Greyhound are home free in computer leasing.[6]

In other words, investors may believe the absence of a "subject to" qualification means a company's financial statements are not affected by significant uncertainties, but business risk is unavoidable.

A Horse Is a Horse—Of Course

A simple analogy may put the question concerning the auditor's responsibility for reporting on uncertainties in perspective. When he was later questioned about the significance of the hearings held by his committee on Watergate, Senator Ervin is reported to have said: "You can either draw a picture of a horse or you can draw the picture and put a caption under it that says 'a horse.' We drew a picture of a horse." The auditor's "subject to" qualification is analogous to the caption on the picture. Is it necessary to put a caption on the picture, or is it adequate simply to draw a clear picture?

If the financial statements adequately portray the uncertainties and their possible effect, is it really necessary for the auditor to issue a qualified opinion?

Future Shock Hits Accrual Accounting

The basic problem of portraying uncertainties in financial reporting is that financial statement amounts are traditionally presented as single values, but only a probability distribution giving a range of values can reflect reality under conditions of uncertainty. The present accounting model developed when the world was simpler and the task of accounting less complex.

Accrual accounting developed in the fifteenth century. The usual venture took about a year, the approximate time of a ship's roundtrip voyage, and at the end of each voyage the accounts would be settled and the investors would receive their

share of profit. Accounting for a single venture such as the voyage of the ship is much simpler than reporting the continuous activity of modern business.[7] Also, events that affect business are taking place at an increasingly rapid rate. One accountant has observed that a shoe manufacturer in 1870 would have experienced little difference in his products, customers, or techniques either twenty years earlier or twenty years later. Today, however, a shoe manufacturer is likely to run the gamut from Indian sandals to kinky boots in two to three years.[8]

Financial statements are imprecise for several reasons, but the major problem in measuring earnings is uncertainty about the future. The current concept of earnings is an *index* of success, and earnings under accrual accounting are determined by a long-range averaging process. Ideally, under accrual accounting earnings and cash ultimately will be equal in amount but there will be differences in timing.

Earning Power and Earnings Cycles

The essence of a company's earning power is its ability to generate cash in the future, but ability to generate cash is not the same as cash generated. The Trueblood Report on the objectives of financial statements explains the relationship between cash generation and earnings:

> . . . Cash generating ability and earnings are closely related and the longer the period, the closer the relationship. For a relatively short period like a month, a quarter, or even a year, net cash flows . . . will differ from earnings because of changes in such items as receivables, payables, inventories, and plant. For such relatively short periods, the accrual basis provides a more useful measure of enterprise progress than the cash basis. Over longer periods, cash generation and earnings come closer together. Over the entire life of an enterprise, they are the same.[9]

At various points in a company's life span not all transactions will be complete. Some series of related transactions extend over several annual periods. The Trueblood Report refers to these related activities as earnings cycles:

> A simple earnings cycle may be identified quite easily; but for most series of transactions, it is usually quite difficult to determine when a cycle has been completed. For example, an enterprise makes a sacrifice by purchasing a plant to produce goods. In this case, the sacrifice (the cash disbursed) can be identified. But the benefit (the cash receipt) relates in some way to each unit being made, sold, and eventually realized as cash. A further benefit may arise from a cash receipt on disposal of the plant. Until the plant is sold, some of the benefits relating to the initial sacrifice for the plant will have been realized through its use in manufacturing, and some will not. Therefore, this requires estimates of the amount of the sacrifice applicable to a certain time period, whenever all benefits are not realized within that time period. Such allocations of sacrifices (or of benefits in other situations) introduce the need for additional judgments in accounting for cycles.[10]

Debits and Credits in an Uncertain World

Accountants have adopted various concepts and conventions to deal with the problems caused by incomplete earnings cycles. These concepts, however, attempt

to eliminate the effect of uncertainty rather than explain it.[11] One of these concepts is realization. Revenue is not normally recognized without some objective evidence such as an exchange transaction and the receipt of cash, or some evidence that receipt is highly probable. An attempt is made to match the sacrifices made in earning revenue against the revenue recognized in a period since the effort to earn revenue may stretch over several accounting periods. Costs incurred for future benefit are assets. A cost is not carried forward to future periods unless the amount is expected to be recovered through future operations.

Another accounting convention adopted to facilitate allocating costs among future periods is the going concern assumption. A company is assumed to have an indefinite life unless some major event, such as bankruptcy, proves the assumption wrong. This allows the allocation of costs over the useful life of an asset and avoids the problem of determining the remaining life of a company.

Another traditional accounting convention is conservatism. The operating rule for conservatism is "anticipate no gains but provide for all losses." Predicting the future is extremely difficult. Consequently, in the absence of an exchange transaction, for example, indicating that merchandise has been sold for a loss, or the occurrence of an event such as a fire that destroys a company's plant, knowing when the value of an asset has been impaired and when the loss should be recognized is also difficult.

Anticipating Future Costs and Losses

When the Pennsylvania-New York Central Transportation Company was formed by the merger of two railroads in 1968, the company charged off costs and losses of $275 million. Penn Central's controller described that charge as "a bookkeeping loss" and stated that the company was only clearing the decks for the merger and that the substantial charge would avoid a drag on earnings for the next ten years.

Leopold A. Bernstein surveyed the reserves for future costs and losses so popular in the late 60's and early 70's and concluded that charges like the Penn Central's indicated real problems in accounting. Professor Bernstein questioned the appropriateness of reaching ten years into the future and expressed the view that reserves for future costs and losses were all too frequently income smoothing and shifting devices.[12]

The problem of when to recognize future costs and losses is important, but it is only a symptom of deeper problems in accounting for uncertainties.

The FASB Puts a Hold on the Future

Anticipating future costs and losses is an application of conservatism in accounting and independent auditors have had difficulty arguing that such anticipation is not in accordance with generally accepted accounting principles.

At one time, the applicable pronouncement was the AICPA's Accounting Research Bulletin No. 50 on contingencies, issued in October 1958. Contingencies were defined as "an existing condition, situation or set of circumstances involving a considerable degree of uncertainty which may through a related future event result in the acquisition or loss of an asset or the incurrence or avoidance of a liability." ARB No. 50 indicated that when contingencies were not sufficiently

predictable to permit recording, they should be disclosed if there was a reasonable possibility of an outcome that might affect financial position or operating results. However, when the outcome of a matter was reasonably foreseeable, the expected result should be recorded.

ARB No. 50 made the recording of a loss dependent entirely on the ability to estimate the amount, and anticipated losses due to a contingency could be recognized in a period prior to the actual incurrence of a loss. The legacy of ARB No. 50 was a paradox for independent auditors.

Under ARB No. 50 accounting principles required that if an item could be estimated, the effect should be recorded. If an estimate could not be made, the conformity of the financial statements with generally accepted accounting principles was indeterminable. The resolution was identifying the "subject to" qualification as the hallmark for the existence of an uncertainty precluding conformity with generally accepted accounting principles.

The Financial Accounting Standards Board took up the question of contingencies in 1973 because of abuses in accounting for future losses. The project was expanded to a consideration of accounting for all contingencies. In March 1975, the FASB issued Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies." It was intended to eliminate the practice of accruing for potential future losses that would not be incurred until a period after the date of the financial statements. The FASB added a requirement that a loss must relate to a current or a prior period in addition to being reasonably estimable. Thus, the requirement of reasonable estimation of ARB No. 50 is no longer sufficient to support recording.

FASB Statement No. 5 also redefines a contingency as an ". . . existing condition, situation, or set of circumstances involving uncertainty as to possible gain . . . or loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability." Recording of a loss is, therefore, dependent on the outcome of some definable future event that may or may not occur. This definition distinguishes estimates required for contingencies from other estimates that relate to matters requiring approximation of amounts or of the timing of transactions. Also, there must be a possibility that the event may not occur. If occurrence is not uncertain, the matter is not a contingency. For example, amounts owed for services received such as advertising and utilities may need to be approximated, but there is no doubt that the service has been received.

All Contingencies Are Not Alike

Contingencies can be conveniently classified into two types. Some contingencies are a recognized part of incomplete earnings cycles. They result from normal recurring activities and the need to make estimates is known even though the amount and timing of future receipts or payments may be uncertain. Examples are estimation of the collectibility of receivables resulting from credit sales, loans, or similar transactions and recognition of obligations under warranties for products or services sold. If, based on available information, future collection or payment of such items is probable and their amounts can be estimated, the effects should be recorded and reflected in financial statements.

Other contingencies result from events that are unusual or infrequent. Since these events are not inherent in earnings cycles, identifying those that should be recorded or disclosed can be difficult. Statement No. 5 applies the same criteria to these events as is applied to estimates inherent in earnings cycles. If occurrence of a future event is probable and the amount can be estimated, the effects should be recorded. If occurrence is only reasonably possible rather than probable, the event should be disclosed.

Gulf & Western was told by an Appellate Court that its tender offer to Atlantic and Pacific Tea Company's shareholders was deficient because it failed to disclose a contingency arising from an antitrust violation. The court held:

> The fact that, at the time it announced its tender offer, an antitrust action had not been commenced against G & W, and that its liability was uncertain, does not excuse G & W's failure to disclose all these relevant circumstances so that A & P shareholders could weigh them in reaching their decision whether or not to tender their shares. As we said in SEC v. Texas Gulf Sulphur Co., 401 F 2d 833,849 (2d Cir. 1968) (en banc), the disclosure requirements of the securities laws require "nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative experience in reaching their own investment decisions with knowledge equal to that of the insiders." Those "basic facts" bearing upon G & W's possible liability for antitrust violations were of obvious concern to those A & P shareholders who retained part of their holdings.[13]

A possible antitrust action is one example of an unasserted claim. FASB Statement No. 5 requires that such claims be disclosed if their assertion is probable and an unfavorable outcome is reasonably possible. Unasserted claims may be known to management of a company, but they can be difficult for an auditor to identify unless the auditor is informed of the possible claims by a company's management or its legal counsel. The outcome is usually impossible for anyone to predict.

Antitrust actions frequently result in "subject to" qualifications when auditors are aware of the action. For example, the Otter Tail Power Company's auditors qualified their opinion on its 1974 financial statements and included the following description of the uncertainty in their report:

> As discussed in the second paragraph of Note 7 to the Financial Statements, the Company is a defendant in suits brought by three municipalities charging antitrust violations and seeking treble and punitive damages totaling $4,386,593. Since the ultimate outcome of the lawsuits cannot presently be determined, no provision for any liability that may result has been made in the financial statements.
>
> In our opinion, subject to the possible effect on the financial statements of the outcome of the litigation discussed in the preceding paragraph, the above-mentioned financial statements. . . .

Other government actions resulting in possible losses may be equally difficult for the auditor and the company to identify. In 1971, for example, Abbot Laboratories' operations were interrupted by the government's recall of its U.S. produced intravenous solutions. Abbott was unable to reenter the market for intravenous solutions for four months, which had a depressing effect on its results

of operations. The beverage industry was also seriously affected when products containing cyclamates were banned. Events of this type are difficult or impossible to predict and future operations may be seriously affected when they occur.

The impossibility of predicting all events that may materially affect a company's operations has led some accountants to agree that uncertainty qualifications may result in undue expectations by investors. The absence of a "subject to" qualification may lead investors to incorrectly conclude that a company has no significant uncertainties.

Should New Guidance on Contingencies Change Auditors' Responsibilities?

FASB Statement No. 5 supplies welcome clarification of when to record and when and what to disclose concerning contingencies. Given the possible importance of such uncertainties to a company's operations, clear guidelines are beneficial to investors, auditors and the management of companies. Since Statement No. 5 has clarified this area of financial reporting, some accountants believe that "subject to" qualifications are now unnecessary.

The possible outcome of a lawsuit is perhaps the best example of a significant unusual uncertainty. Armstrong Cork Company's 1974 annual report discloses it was involved in litigation concerning patent infringement. The auditors' report and related footnote disclosure appear in Exhibit I. When such contingencies are disclosed, it is relatively easy to separate the business risk from the information risk. As long as investors are given enough information, there is no information risk. Financial statements may disclose but cannot reduce the business risk. The ultimate effect on the financial statements depends on the outcome of an identifiable future event. The type of probabilility evaluation involved here should be distinguished from the probability of events that are inherent in an earnings cycle. The estimation of the collectibility of receivables, for example, depends on a probability evaluation that normally involves a large number of homogeneous items. This is the classical view of probability—a concept of relative frequency which is normally applicable only to a large number of items with similar characteristics. On the other hand, a lawsuit is a unique event and the classical view of probability is not applicable. A unique event will have only one outcome—either favorable or unfavorable.

For unique events, the auditor's "subject to" qualified opinion can only emphasize a matter already spelled out for investors in financial statements. An auditor's qualification adds little and may lure investors into a false sense of security.

Since Statement No. 5 provides understandable guidance on when accounting for the future should stop, some justification exists for removing the auditor's reporting obligations for uncertainties. However, Statement No. 5 does not cover all uncertainties and the prohibition against recording certain contingencies raises other problems.

Thou Shalt Not Record

Statement No. 5 prohibits recording if the amount cannot be reasonably estimated or if the event on which the amount is contingent is not probable. The difficulties that might be caused are highlighted by a current problem of hospitals.

Malpractice suits normally involve astronomical sums and some result in

significant settlements. As a result, doctors and hospitals are having difficulty in obtaining malpractice insurance. Insurers are reluctant to offer malpractice coverage because of the difficulty of estimating future losses. That gives the hospitals both operating and accounting problems. If a hospital is unable to obtain malpractice insurance or must co-insure a large amount of the risk, an individual hospital will have even more difficulty than an insurer estimating the losses for malpractice claims.

If a hospital makes a provision for malpractice losses when the amount cannot be reasonably estimated, it will violate FASB Statement No. 5. A hospital's auditor might then include the following middle paragraph in the audit report:

> As described in Note X, claims for alleged malpractice in excess of insurance coverage have been filed against the hospital by various claimants. In addition, the hospital has no assurance that additional material claims will not be asserted arising out of services provided to patients in the past. The ultimate liability of the hospital resulting from these claims is not presently determinable. Further, as discussed in Note X, the hospital has charged to income a provision for losses, relating to uninsured malpractice claims. Because of the uncertainties described above, the amount of such a provision and the related liability cannot be reasonably estimated.

Someone familiar with the requirements of FASB Statement No. 5 might conclude the auditor's opinion paragraph should object to the departure from generally accepted accounting principles—an "except for" qualification. However, some auditors can be expected to conclude a "subject to" opinion is permissible. After all, "subject to" qualified opinions are supposed to be used for uncertainties and this is an uncertainty.

When faced with similar past problems, auditors have sometimes opted for "subject to" qualifications. In the "big bath" days of the late 60's and early 70's, the special reserves for future losses complained about by Professor Bernstein also produced some interesting auditor's reports.

Allis-Chalmers Manufacturing Company, in its 1968 annual report, announced a change in management. The incoming officers adopted new policies on organization, products, production facilities, marketing, and relations with dealers and customers that resulted in recording special reserves in the last quarter of 1968 totaling $68.7 million. For the year, the final loss was $54 million *after recording future tax benefits of $43 million.*

Even after that loss, the auditors were not certain enough to express an unqualified opinion and issued an opinion "subject to" two uncertainties. This is the middle paragraph of their report:

> As explained in Note 3 to the financial statements, in the last quarter of 1968 the Company recorded substantial amounts associated with (a) reserves for anticipated costs and losses, and (b) estimated income tax benefits expected to be realized in the future. Although these reserves and anticipated tax benefits reflect the best current judgment of the Company's management, we cannot determine at this time the amounts of costs and losses which ultimately will be charged against the reserves, and the amounts of future tax benefits which ultimately will be realized.

The unusual aspect of this special reserve was the effect on the auditor's opinion of the related income tax effect. Allis-Chalmers obtained a refund of

only $14 million on past taxes. That left $50 million plus to be claimed in future years should earnings be adequate. Even though the auditors were uncertain about future tax benefits that would be realized, those tax benefits were recorded as an asset and the related gain reduced Allis-Chalmers' loss for the year.

APB Opinion No. 11 explains the generally accepted accounting principles for handling the complex differences between the taxes paid in a year and the tax expense recognized in an income statement. Opinion No. 11 provides that ". . . in those rare cases in which realization of the tax benefits of loss carryforwards is assured beyond any reasonable doubt, the potential benefits . . ." may be recorded.

Thus, generally accepted accounting principles require a significant degree of certainty before recognizing future tax benefits. The prohibition against recording future tax benefits is similar to the prohibition in FASB Statement No. 5. In both cases, a significant uncertainty may exist that would prevent recording. When generally accepted accounting principles prohibit recording, an auditor should object to the violation with an "except for" qualification. Nevertheless, the desirable features of a "subject to" qualification may cause auditors to focus on the uncertainty rather than on the resulting departure from generally accepted accounting principles.

In addition to the murkiness that may be caused by the uncertainties that Statement No. 5 prohibits recording are the uncertainties on which Statement No. 5 offers no guidance.

Contingencies, Commitments and Conundrums

Statement No. 5 excludes several matters that come under the heading of uncertainties in accounting.

Among the matters excluded are contingencies inseparable from other measurements inherent in earnings cycles. For example, depreciation is excluded because "the eventual expiration of the utility of the asset is not uncertain."

Another major category of accounting measurements excluded from Statement No. 5 is impairment of asset values arising from current conditions rather than depending on the outcome of future events. Some of these measurements are covered by other pronouncements: marketable securities (FASB Statement No. 12), inventory pricing (ARB No. 43), investments in common stock accounted for by the equity method (APB Opinion No. 18) and losses arising from disposal of a segment of a business (APB Opinion No. 30).

Losses on operating assets, such as plant and equipment, arising from changed current economic conditions are also excluded.

The appropriate accounting period to be charged for a loss from a contingency is also not covered by Statement No. 5. The criteria for prior period adjustments established by APB Opinion No. 9 remain unchanged.

The Silver Lining of "Subject to"

The correct period to be charged for a loss causes difficulty in accounting. There will always be differences between the estimations made and the actual results. Consequently, accountants have developed criteria for deciding whether the difference should be charged to the period when the estimate was made or to the period when the difference between the estimate and the result is determined.

If the difference is viewed as a correction of income reported in earlier periods, substantial losses or gains may escape the income statement and the attention of investors. On the other hand, reporting the differences in the current income statement may distort the measurement of a company's normal, recurring earning power.

Opinion No. 9 limits prior period adjustments to material adjustments that:

> (a) can be specifically identified with and directly related to the business activities of particular prior periods, and (b) are not attributable to economic events occurring subsequent to the date of financial statements for the prior period, and (c) depend primarily upon persons other than management, and (d) were not susceptible of reasonable estimation prior to such determination.

Opinion No. 9 also observes that in most cases the opinion of the independent auditor on the financial statements of the prior period would have contained a qualification because of the uncertainty. A "subject to" qualification is not one of the criteria for determining a prior period adjustment, but there is a strong implication that the presence of a qualified opinion will make prior period treatment more justifiable. Research by Samuel Laibstain and Thomas Huff suggests that the type of auditor's opinion does have a direct relationship to the accounting period charged for subsequent adjustments. They observe that the relationship between the auditor's opinion and prior period adjustment treatment may make management more inclined to accept "subject to" qualifications:

> If the auditor's opinion does govern subsequent accounting treatment of the error, another result may be that management often will readily accept a qualified opinion if it suspects that actual results may be significantly worse than its estimate, reasoning that subsequent adjustment will be to retained earnings.[14]

Indeed, in its 1974 annual report the management and independent auditors of Del E. Webb Corporation complain bitterly about the denial of prior period adjustment treatment. The middle paragraph of the auditor's report explains the matter as follows:

> Our previously issued accountants' report dated February 28, 1974 on the 1973 consolidated financial statements was qualified subject to the effect of the resolution of the claim against the Government of Honduras. Included in the accompanying consolidated statement of earnings for the year ended December 31, 1974 is a charge of $2,749,444, representing the write-offs of amounts recorded in connection with this claim (as more fully explained in note 2 to the consolidated financial statements), which the management of Del E. Webb Corporation believes should have been recorded as a prior period adjustment. It is our opinion that it would have been preferable to accord this charge prior period adjustment treatment, which would have increased 1974 net earnings by $1,474,549 ($.17 per share).

Note 2 to the financial statements explains that the SEC insisted that the $2.7 million charge appear in the 1974 results of operations.

This SEC action does not seem to be an isolated example. In fact, the SEC staff seems to have embarked on a campaign to eliminate prior period adjustments and the FASB is also reported to be working on the subject. If prior period

adjustments become a thing of the past, "subject to" qualifications will make even less sense.

The auditor's qualification could be viewed as pointing out to investors that the financial statements being reported on might be adjusted at some future date when the uncertainty is resolved. Some accountants have suggested "subject to" qualifications should be used only when the financial statements might be adjusted. If any gain or loss would be shown in the financial statements of a future period, the financial statements reported on would never be changed. Henry Hill states the case:

> Auditors should take care that they let the financial statements speak for themselves. When uncertainties arise, a careful analysis should be made to see whether unfavorable resolution will have an effect on the current financial statements. "Subject to" opinions should be limited to events that will have such an effect. Other contingencies should be clearly recited in the financial statements in the interest of full disclosure, but this does not mean they are a proper component of the auditor's report. In other words, as far as uncertainties are concerned, the factors that lead to retroactive restatement should be precisely the same as the factors leading to a "subject to" opinion.[15]

The fact that either favorable or unfavorable resolution of uncertainties with respect to an earlier year's financial statements may cause no adjustment of those statements violates intuitive logic, but as Mr. Hill observes.

> Logic may not always prevail . . . where debits and credits are involved, for such a solution invites debits to the rear, credits to the fore. The policing instinct of auditors makes them shrink from encouraging practices which permit omission of recording of losses from the current year's financial statements. . . . One way to resolve the problem would be to do away completely with "subject to" opinions where estimates are involved. This would not further the interests of the financial statement reader, however, and it would deny the auditor some protection.[15]

Prediction, Protection and Professionalism

Two critical questions are whether the interests of financial statement readers are furthered by "subject to" qualifications and whether the independent auditor receives any protection from them.

A "subject to" qualification does post a warning to investors that financial statements reported on by the auditor may need to be changed. However, many uncertainties when resolved will not result in retroactive restatement of financial statements and the number of uncertainties that will receive prior period adjustment treatment grows smaller every day. Another reason for posting a warning might be implementation of a new idea being pushed by the SEC staff that disclosure is required whenever historical operating results may not be indicative of future results because of some matter within management's knowledge.[16]

At this date, however, generally accepted accounting principles and the rules of the SEC do not require such disclosures in financial statements. The only place that the SEC requires such disclosure is in management's discussion and analysis of the summary of operations which is not part of the financial state-

ments. Even if the necessity of disclosing such matters in the financial statements were acknowledged, there is no compelling reason to believe that adequate disclosure would not sufficiently warn investors.

The essential question then becomes whether investors need or want a prediction of future events or whether they would be better served by information that would allow them to make their own assessments of whether the risk inherent in the company's activities is one they will accept. Contingencies by definition depend on the outcome of future events. Contingencies involving infrequent or unusual future events are not susceptible to normal estimation methods. The Trueblood Report recognizes distinctions are necessary among different kinds of measures that vary in the certainty of their ultimate impact on cash. The view taken of earnings measurement in the Trueblood Report assumes ". . . users generally will want to make their own judgments about uncertainty."[17]

Contingencies involving infrequent or unusual future events should be fully disclosed. Investors should be given enough information to make their own assessment of risk. This conclusion does not fully resolve the auditor's responsibility because other uncertainties may also cause a "subject to" qualification.

Are Asset Evaluations Uncertainties?

The carrying amount of an operating asset may exceed the amount expected to be recovered through future use of the asset because of current conditions that make recovery of the carrying amount doubtful. For example, the Callahan Mining Corporation at the end of 1974 did not know whether one of its mines could be operated because of geological risks involved in deep shaft exploration. The auditor's qualified opinion and the related note to management's financial statements appear in Exhibit II.

Operating assets are used over many accounting periods and a company may not intend to dispose of the assets in the near future. Even though the estimation of the appropriate carrying amount of the asset depends on current conditions, the accuracy of that estimate cannot be determined with certainty unless the asset is sold or abandoned. Also, if the asset is disposed of at a loss at a future date, the loss may have arisen in subsequent periods. Thus, the amount realized may not indicate the appropriate carrying amount at an earlier date.[18]

Another problem in determining the appropriate carrying amount of an asset is that most assets are used jointly to generate future receipts of cash. The contribution of an individual asset to the earnings process cannot be determined uniquely when it makes a joint contribution.

The contribution that the auditor can make has some limitations because of the number of factors involved in determining the appropriate carrying amount of an asset. The auditor can determine that the asset exists and that it is owned by the company, but the uncertainty surrounding the future cash receipts that will result from using the asset makes evaluation of the appropriate carrying amount difficult.

Auditors' opinions are qualified "subject to" the company's ability to recover the carrying amount of assets. Whether disclosure of those uncertainties would be sufficient without qualification is a critical question. Statement No. 5 offers no guidance.

The SEC Fills the Disclosure Gap

In late 1974 the SEC issued Accounting Series Release No. 166 on the disclosure of unusual risks and uncertainties in financial reporting. ASR No. 166 recognizes that additional disclosures may be necessary when:

- Special circumstances affect a company's ability to measure current results.
- Current economic conditions have changed the risk characteristics of assets.
- Assumptions underlying the use of certain accounting principles have become subject to substantial uncertainty.

All of the examples in ASR No. 166 relate to the carrying amount of assets such as loan loss reserves for financial institutions, marketable securities, and the operating assets of some companies with a small number of projects that have a dominant effect on operating results. Examples of projects with a dominant effect include major aircraft by aircraft manufacturers and construction contracts by contractors.

The following recommendation in ASR No. 166 seems to be the prototype:

> The disclosure should include a description of the unusual circumstances involved, a description of the types of assumptions made by management when preparing financial reports, and an indication of the sensitivity of current and prospective earnings to changes in such assumptions caused either by changing circumstances or the final determination of the uncertainties involved.

The thrust of the ASR seems to be to put disclosure of uncertainties concerning the carrying amount of assets on the same basis as contingencies. The disclosure recommendations highlight uncertainties and describe the sensitivity of operating results to estimates. The notes, in effect, suggest the probability distribution behind the single amount in the financial statements.

When Is Disclosure Not Enough?

The recent decisions, one by the Federal District Court for the Southern District of New York and the other by the SEC in an administrative proceeding illustrate that a "subject to" opinion will be of little value to an investor, or to an auditor defending an action, if the extent of the disclosure about the uncertainty causing the qualification is inadequate. The administrative proceeding involved an audit of Talley Industries, Inc. (Talley) by Peat, Marwick, Mitchell & Co. (PMM).

Talley was engaged in the manufacture and distribution of various products, including bomb racks and pyrotechnics designed for the U.S. Armed Forces. In connection with a proxy statement being distributed to solicit approval of the merger of Talley with another company, PMM issued a qualified opinion on Talley's financial statements for the year ended March 31, 1969. The opinion was qualified "subject to" Talley's ability to obtain sufficient future contracts as referred to in Note 3 to the financial statements. Note 3 stated:

> The Company bases its calculation of inventories and of cost of sales ap-

plicable to fixed price United States Government contracts on the costs (including administrative overhead) incurred and estimated to be incurred on the relative production programs. For the purpose of computing sales, these costs are prorated over the estimated total revenues for such programs. The estimates are based on actual contracts on hand and future contracts expected by management to be obtained. The resultant value of inventories on this basis at March 31, 1969, is approximately $8,900,000 in excess of the prorated cost of actual contracts on hand and such excess is believed to be larger at December 31, 1969, but management expects sufficient future contracts to be received to recover such excess.

The SEC found the opinion and related footnote to be materially deficient in the following respects:

- The note did not disclose the dollar amount of future contracts ($100 million) which Talley's management estimated would be obtained.
- Since recovery of excess costs was dependent in part on Talley's achieving projections of material savings in production costs, the report should also have been qualified with respect to Talley's ability to perform contracts in a profitable manner.

The PMM proceeding does not have the authority of case law, and PMM for purposes of the settlement order neither admitted nor denied any of the statements or conclusions of the SEC, but the position taken by the SEC on qualified opinions is instructive. The lesson is that the SEC will look beyond the words of qualification to determine whether adequate disclosure has been made in the auditor's report, the financial statements, or in the related footnotes, of the uncertainty causing the qualification.

The SEC's analysis of the Talley case emphasized the difficulty and subjectivity of the prediction. In projecting future sales, Talley had to predict the total dollar amount of future contracts for a particular product to be awarded by defense agencies and the portion of the total market for that product they would be successful in capturing. Underlying the SEC's criticism seems to be the belief that the projection of $100 million in sales when Talley had a backlog of orders of only $24 million required something more than a "subject to" qualification. The SEC stated:

> . . . we believe that the auditors relied too heavily upon the representations, projections and estimates made by Talley's management and did not require sufficient documentation and evidential matter to enable them to review adequately the sales projections and cost estimates for reasonableness.

In such circumstances, disclosure may not be enough.

Everything You Ever Wanted to Know About an Uncertainty and More

The other case implies that disclosure may sometimes be enough, but that a "subject to" qualification is a poor substitute. In *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath,*[20] the critical transaction involved the purchase by The Firestone Group, Ltd. (FGL) of certain nursing homes on November 22, 1969 for $13 million and their subsequent sale four days later for $15 million to a company run by a Mr. Ruderian. Both the purchase contract and the sales contract

provided for a payment of $5,000 on execution of the contract, $25,000 approximately one month later, a payment of $4 million (on FGL's purchase) or $5 million (on FGL's sale) on January 30, 1970, with remaining amounts to be paid over a period of 25 years in monthly installments. The auditor's opinion on FGL's financial statements was qualified "subject to the collectibility of the balance receivable on the contract of sale (see Note 4 to the Notes to Financial Statements)." Note 4 set forth the basic terms of the contracts of purchase and sale and stated that of the total profit of approximately $2 million only $235,000 was included in income, with the remainder deferred until payment was made on January 30, 1970.

The sale of the properties by FGL was never accomplished as FGL went bankrupt, and certain investors in FGL brought suit against the auditors, alleging that the financial statements did not disclose material facts known by the auditors concerning the purchase and sale contracts. The auditors argued that their qualification and the disclosures in the note to the financial statements adequately alerted potential investors to doubts the auditors had about the collectibility of this significant account receivable.

The court rejected the auditor's argument, stating that:

> We agree that the qualification throws some doubt on whether the transaction would be culminated, but we think more was required of Laventhol as an independent auditor. Each investor was entitled to decide for *himself*, on the basis of the stark facts, whether the transaction had a realistic prospect of being completed. The information needed to make that judgment and known to Laventhol was not disclosed in the Laventhol report. (Emphasis in original)

The court stated that the auditors should have disclosed such facts as that the party buying the properties had a net worth of only $100,000, and that the president and controlling stockholder of the buyer, Mr. Ruderian, was not personally liable on the sales contract.

The full litany of the disclosures suggested by the court follows:

> Thus, we believe that the full disclosure mandated by the Act required Laventhol to include in its report *at least* the following facts: (1) Continental's net worth; (2) the ambiguity of the language in the contracts which might have suggested to some that they were options; (3) Ruderian, on whose reputation and representations Laventhol was depending, was not personally liable on the contracts; (4) Ruderian's practice of reselling property before he paid for it; (5) neither of the transactions was recorded in FGL's books of original entry or corporate minute books; (6) this transaction was the largest in which FGL had ever participated; (7) FGL would show a loss if the income from the Monterey transactions were not realized; (8) FGL had not acquired title to the nursing home properties from Monterey; (9) no deed, title search or title insurance on the properties had ever been obtained by FGL; and (10) the legal opinion sought by Laventhol, on which it relied in treating the transaction as an enforceable purchase and sale, had been obtained over the telephone from an attorney who not only never saw the contract but never even had it read to him on the telephone.

The court seems to have emphasized the need for adequate disclosure by

throwing in everything that might possibly be disclosed. The decision is presently being appealed and the disclosure burden imposed has been criticized. However, the court's message is clear. The important thing is the adequacy of disclosure and providing the investor with enough information to make a personal assessment of the possible outcome of the uncertainty. The auditor's "subject to" qualification alone does not do that. The inescapable question is: If the financial statements contain enough disclosure to allow the investor to make appropriate assessment, is there any need for the "subject to" qualification?

Many accountants are coming to the conclusion that the "subject to" qualification serves little purpose for most uncertainties. The financial statements can and should give a clear picture of the company's status and prospects along with a description of the uncertainties that make an accurate picture impossible. However, these accountants would like to hang on to the "subject to" qualification for the ultimate uncertainty of all—doubt about the company's ability to continue in operation.

The Going-Going-Gone Concern

This point brings us back to where the analysis started with W. T. Grant. A company's ability to continue to operate as a going concern is one of the most fundamental uncertainties faced in the preparation of financial statements. When such doubts exist, auditors have expressed "subject to" qualifications or in severe cases disclaimed an opinion.

The qualification of an opinion because of doubts about a company's going concern status has a number of drawbacks. First, there are no accepted criteria for determining when a company has changed from a going concern to a gone concern. Even the fact that a company has filed for bankruptcy is not conclusive evidence that it will be forced to liquidate. Second, if the decision is made that financial statements should be prepared using liquidating values rather than amounts that would be appropriate for a continuing company, there are no generally accepted accounting principles to explain how those financial statements should be presented.

Research indicates that analysis of financial statements is probably a better method of evaluating a company's future prospects than relying on a qualified opinion. Edward Altman and Thomas McGough prepared a quantitative model based on ratios of financial statement amounts. Generally, their bankruptcy model proved to be the better predictor of company failure. Altman and McGough explained the relationship between their model and the auditor's report as follows:

> The bankruptcy model and the auditors' report have different but analogous functions. The model was developed to predict bankruptcy. The auditor does not attempt any such prediction. An unqualified opinion is not a guarantee that a company will continue as a going concern, but an exception because of going-concern problems is not a prediction of liquidation. An opinion expressing doubts concerning a company's ability to continue as a going concern is based on the uncertainty of the fairness of presentation of the financial statements. It would be possible for financial statements based upon historical cost to be fairly presented when the company is facing bankruptcy if the carrying value of the assets of that company represents the realizable value of those assets.[21]

Thus, the effect of the going concern question on the auditor's report is not significantly different from the concern with the impairment of asset values based on an evaluation of current economic conditions. It is doubtful that the going concern assumption adds anything to the concept of realization. The auditor's concern with asset realization and the amount and classification of liabilities would be the same without any going-concern assumption because of the realization concept.

Another drawback is that the auditor's qualification is a "self-fulfilling prophecy." A company's financial and operating difficulties should be apparent from its financial statements. A "subject to" qualification only adds to a company's problems and may hasten its demise. Accounting Series Release No. 115 adds a new dimension because it puts the auditor in the position of deciding whether a company is able to obtain more funds to continue operations. The SEC will not accept a "subject to" qualification based on a company's going concern status in a registration statement. Thus, a company unable to continue operations unless it obtains more funds cannot obtain those funds by a public offering of securities.[22]

The auditor's present responsibilities for reporting on uncertainties may force him to predict future events and analyze the company's future prospects. These may be useful functions, but the question is whether they are compatible with the auditor's role and whether an auditor is competent to effectively perform them.

What Is the Auditor's Role?

The auditor's role is to add to the credibility of financial information. Information risk and business risk should not be confused. Financial information should portray the risks under which a company operates. Predicting the outcome of future events and hence attempting to eliminate those risks from financial statements is incompatible with the auditor's basic role.

If disclosure in the financial statements is adequate and the auditor's "subject to" qualification adds nothing, the availability of that qualification may cause the auditor to stop short of insisting on all the disclosures necessary to inform investors and place them in a position to evaluate the outcome of uncertainties. Further, the fact that auditors do issue "subject to" qualifications may lead investors to think that the absence of a "subject to" qualification means that the company has no significant uncertainties. In other words, investors may be led to rely on the auditor to evaluate business risk when the essence of investing is evaluating business risk and taking a chance on the outcome. Auditors should not accept a responsibility that would tend to shift some portion of business risk to them. Their function is to minimize the information risk. The auditor's attention should be freed for an evaluation of the adequacy of disclosure concerning uncertainties.

Under present requirements, some matters closer to departures from generally accepted accounting principles that cannot be evaluated by investors receive "subject to" qualifications because they contain an element of uncertainty. A distinction is called for between contingencies involving unusual or infrequent events that depend on an unpredictable future outcome and questions concerning the impairment of asset values based on current economic conditions. Disclosure is probably adequate to inform investors about such contingencies. For other

matters presently called uncertainties, auditors must evaluate the adequacy of disclosure and consider whether the failure to recognize a loss or recognizing an uncertain profit is in reality a departure from generally accepted accounting principles. A departure will exist whenever generally accepted accounting principles require a reasonable estimate that does not depend for its resolution on the outcome of a future event. If the auditor does not believe disclosures of the type recommended by ASR No. 166 adequately portray the business risk, a "subject to" qualification is inadequate.

Thus, I recommend that the requirement to issue a "subject to" qualification be eliminated. It is not an appropriate responsibility for auditors. However, the term "uncertainties" has been used too broadly, and careful distinctions must be drawn between contingencies for which no qualification is required and other matters that under my recommendation may be either departures from generally accepted accounting principles or matters of insufficient evidential matter requiring the auditor to issue a qualified opinion or disclaim an opinion because of a restricted examination.

Future Accounting for the Future

As generally accepted accounting principles are developed, much more will have to be done to make investors aware of the uncertainties involved in the preparation of financial statements.

The Trueblood Report contains recommendations that would improve the ability of investors to identify and evaluate uncertainties.[23] For example, it recommends that ". . . basic underlying assumptions with respect to matters subject to interpretation, evaluation, prediction or estimation should be disclosed." It also contains a number of other ideas that would improve disclosure and presentation of uncertainties. For example:

- Classify assets and liabilities by uncertainty of amount and timing of cash flows rather than on the basis of liquidity.
- Separate operations into complete and incomplete earnings cycles and disclose the results of those cycles separately.
- Disclose ranges of precision, reliability, and uncertainty rather than single valued estimates.

Implementation of the recommendations of the Trueblood Report may be a long way off and until the new ideas about providing information concerning the effect of uncertainty on the financial statements can be implemented, some intermediate measures would be worthwhile.

First, the type of disclosure recommended by the SEC in ASR No. 166 could be implemented on a more wide-scale basis. The sensitivity of operating results to the matters affected by significant uncertainties should be routinely disclosed.

Another possibility would be to expand the note on disclosure of significant accounting policies to better explain the assumptions and estimates involved in certain accounting methods. The percentage of completion method for recognizing revenues would be an outstanding candidate for elaboration.

Significant uncertainties are important enough to deserve their own financial statement note, similar to the note on significant accounting policies. Thus, in-

vestors would have one place to look for a description of significant uncertainties instead of being required to read long notes on litigation to pick out an antitrust suit that could put the company out of business. Investors would not need to probe credit agreements to find that one recent agreement has locked up the company's ability to pay dividends, dispose of assets, or enter into any new debt arrangements.

The auditor's role in evaluating these disclosures would be difficult. In many ways it may be more difficult than the present responsibilities for reporting on uncertainties. However, the auditor's task is to evaluate whether or not the company's financial picture adequately portrays the business risk and not to reduce or assume that risk. An auditor should decide whether the picture is clear enough, rather than worry about whether a caption is necessary to let people know what a poor picture represents.

Footnotes

1. My first exposure to this concept was in "An Examination and Clarification of the Role for Auditing in the Production and Dissemination of Capital Market Information" by Robert E. Hamilton; a dissertation presented to the Faculty of the Graduate School of Business Administration, University of Southern California, May 1975.

2. Henry P. Hill, "Reporting on Uncertainties by Independent Auditors," *The Journal of Accountancy,* January 1973, pp. 55-60.

3. Louis H. Rappaport, *SEC Accounting Practice and Procedure,* Third Edition, The Ronald Press Company, New York, 1972, pp. 2520-2521. (The same comment appeared in the First Edition in 1956.)

4. Carman G. Blough, "SEC Release on Opinions and Opening Inventories," *The Journal of Accountancy,* May 1962, pp. 71-73.

5. "All Numbers are not Equal," *Forbes,* July 1, 1973, pp. 33-35.

6. *Ibid.*

7. The effect of the pace of current events on accrual accounting is from James J. Powers, "Future Shock Jars Accounting World," *The New York Times,* June 2, 1974.

8. This illustration and some excellent observations on the auditor's role are found in A. M. C. Morison, "The Role of the Reporting Accountant Today," *Accountancy,* January 1971 and March 1971.

9. Study Group on the Objectives of Financial Statements, *Objectives of Financial Statements,* AICPA, October 1973, p. 23.

10. *Ibid.,* p. 29.

11. Discussion of accounting concepts and conventions designed to reduce the effect of uncertainties on financial statements is from John Dewhirst, "Dealing with Uncertainty," *Canadian Chartered Accountant,* August 1971, pp. 139-140.

12. Leopold A. Bernstein, "Reserves for Future Costs and Losses—Threat to the Integrity of the Income Statement," *The New York Certified Public Accountant,* July 1970, pp. 541-546.

13. In Gulf & Western Ind. Inc. v. Great Atlantic & Pacific Tea Co., Inc., 476 F 2d 687, 697 (2d Cir. 1973), CCH Fed. Sec. L. Rptr. ¶ 93,814.

14. Samuel Laibstain and Thomas Huff, "The Financial Reporting of Revised Loss Estimates," *Financial Analysts Journal,* May-June 1971, pp. 62-69.

15. Hill, *loc. cit.*

16. The SEC's requirements are explained in Accounting Series Release No. 159, August 14, 1974 on Amendments to Guide 22 and Guide 1.

17. Study Group on the Objectives of Financial Statements, *Op. Cit.,* p. 33.

18. The factors that cause random variation in the difference between estimates about assets and actual results are further explained in William R. Scott, "A Bayesian Approach to Asset Valuation and Audit Size," *Journal of Accounting Research,* Autumn, 1973, pp. 304-330.

19. This case is discussed in Accounting Series Release No. 173, "In the Matter of Peat, Marwick, Mitchell & Co.," Washington, D.C.: SEC, July 2, 1975.

20. U.S.D.C., S.D.N.Y. No. 71 Civ. 2209 (LFM), May 29, 1974, CCH Fed. Sec. L. Reptr. ¶ 94,574.

21. Edward I. Altman and Thomas P. McGough, "Evaluation of a Company as a Going Concern," *The Journal of Accountancy,* December 1974, pp. 50-57.

22. The Release and the burden it places on the auditor to decide whether a company can go public are explained in Lloyd E. Shefsky and Edward J. Schwartz, "Disclosures and Re-

porting under SEC's ASR No. 115," *The Journal of Accountancy,* September 1973, pp. 53-61.
23. The discussion related to improving the communication of uncertainties in financial reporting is found in Chapter 5, particularly pp. 34-40.

Exhibit I

Example of Auditor's Report and Related Note on Outcome of Lawsuit Against the Company

ARMSTRONG CORK COMPANY
Auditor's Opinion

The Board of Directors and Stockholders,
Armstrong Cork Company:

We have examined the consolidated balance sheets of Armstrong Cork Company and subsidiaries as of December 31, 1974 and 1973 and the related consolidated statements of earnings and changes in financial position for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The company is involved in continuing litigation relating to patent infringement. The amount of damages, if any, resulting from this litigation cannot be determined at this time. See Litigation on this page for further details.

In our opinion, subject to the effect on the accompanying financial statements, if any, of the resolution of the matter referred to in the preceding paragraph, the aforementioned consolidated financial statements present fairly the financial position of Armstrong Cork Company and subsidiaries at December 31, 1974 and 1973 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles which, except for the changes in 1974, with which we concur, in the method of valuing inventories and the method of accounting for fluctuations in foreign exchange rates explained on pages 19 and 20 of the financial review, have been applied on a consistent basis.

Notes to Financial Statements

In February, 1975, the Court of Appeals for the Third Circuit affirmed the earlier decision of the United States District Court holding that the company infringed chemical embossing patents held by Congoleum Industries, Inc. The decision applies only to the company's United States manufacture of a certain type of rotovinyl flooring during the period 1967 through 1972. A request for the review of this decision by the Supreme Court of the United States is now being actively pursued.

In 1973 the disputed chemical embossing process used by the company was modified to avoid further claims of infringement. The trial to determine if the modified chemical process infringes the Congoleum patents has been held, and a decision should be forthcoming in 1975.

By January 1, 1975, the company had replaced the chemical embossing technique with a mechanical embossing process involving no question of patent infringement. Accordingly, any injunction issued will not prevent the continued production of rotovinyl flooring by the company.

Suits also are pending in the United Kingdom and Canada involving comparable chemical embossing patents. Neither of these suits has reached the trial stage.

The amount of potential damages, if any, will not be known until all legal procedures have been exhausted. However, with the sales of the disputed rotovinyl material constituting a relatively small share of consolidated sales, it is management's opinion that the potential liability could have no material adverse effect on the business or financial position of the company.

Exhibit II

Example of Auditor's Report and Related Note on Recoverability of Asset Book Value

CALLAHAN MINING CORPORATION
Auditors' Opinion

To the Board of Directors and Shareholders of
Callahan Mining Corporation

We have examined the consolidated balance sheet of Callahan Mining Corporation and Subsidiaries as of December 31, 1974 and the related statements of income and retained earnings

and of changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We previously examined and reported upon the financial statements for the year 1973.

The Company's investment in the Caladay Project is carried at cost, the recovery of which is subject to the success of the project which cannot be forecast at this time, as described in Note 2 to the consolidated financial statements.

In our opinion, subject to the effects on the financial statements of the ultimate realization of the carrying value of the investment in the Caladay Project, the aforementioned consolidated statements present fairly the financial position of Callahan Mining Corporation and Subsidiaries at December 31, 1974 and 1973 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Notes to Financial Statements

2. At December 31, 1974, the Company's investment in the Caladay Project aggregated $3,265,000, including $247,000 representing the cost of property contributed by Callahan and $980,000 representing the net book value of buildings and equipment. The recovery of this investment is subject to the success of the project which cannot be forecast at this time. See page 4.

(Page 4)

Caladay Project

The Caladay Project, which adjoins the Galena mine on the east, remained on a care and maintenance basis during 1974. Escalating costs have made reactivation of the proposed deep shaft exploration program unattractive at present in light of the geologic risks involved. Discussions continue on a less costly alternative approach under which initial exploration of this property may be carried out from one or more of the lower levels of the Galena mine.

In the interest of increased public awareness of mining activities in the District and elsewhere, the Caladay tunnel and underground workings were made available during Expo 74 for underground tours by some 15,000 visitors to the area.

Discussant's Response to Risk and Uncertainty in Financial Reporting and the Auditor's Role

J. Herman Brasseaux
University of New Orleans

Let me begin by saying that Doug Carmichael's paper is a most comprehensive, if not overwhelming, treatment of an extremely timely issue in our profession. The issue has been raised before but not treated in this fashion. The paper is provocative; it calls for a basic change in reporting on uncertainty, and as such, will undoubtedly generate some lively debate.

My views are basically parallel to Doug's (and others') on the central theme of the paper. So, rather than contest his thesis, I will attempt to deal with some of the practical reasons why it may be some time before the profession is ready and willing to take the step recommended in Doug's paper.

The Problem of Uncertainty

A discussion of the auditor's role in this area must include a consideration of the nature of uncertainty as it affects the business enterprise and a consideration of the methodology of reflecting and reporting on uncertainty in financial statements. The business enterprise has experienced increasing complexity over the past two centuries, but especially in the most recent 30 years, and the uncertainty within the business environment has greatly accelerated. Measuring income for a short period such as a quarter or a year and measuring financial position at a given date, when one considers the risk environment of business entities in today's world, is a heroic undertaking indeed! Coupled with this is the fact that our methodology and capability to measure, portray and communicate business uncertainty to the average reader have been and remain inadequate.

Given these problems, it is encouraging that we are making progress in getting a better understanding of the impact of uncertainty and in reporting thereon. FASB Statement No. 5, SEC disclosure requirements in this area, the Trueblood Report, and the soon to be released FASB proposal on the conceptual framework project are but a few examples of our efforts to get a better handle on the uncertainty issue.

A quick look at annual reports being published at this time of the year attests to the literal explosion which is taking place in financial statement disclosure. The notes to the statements frequently run several pages longer than the basic statements and much of the increased disclosure relates to the complexity and uncertainty of the firm's environment. To cite one case in point, the 1975 Annual Report of Occidental Petroleum presents the basic financial statements in *five* pages, but the notes require *nine* pages. The note on contingent liabilities

and commitments, alone, runs over two full pages. The increased disclosure in footnote form may be an indication of the inadequacy of the basic financial statements to convey the full message in technical language form, and hence our tendency is to revert to narrative explanations which are long and inefficient and probably not well understood. One observation is that comparability of financial statements, if this ever was a realistic goal, has suffered a serious setback. Another observation may be that with so much disclosure, the auditor needs a means of calling attention to the most or more important items.

Our greater awareness to the uncertain environment of business and our efforts to better reflect this condition in financial statements are quite germane to our concern with the auditor's reporting responsibility. A difficult question, or perhaps the central question, facing us is whether we have made sufficient progress in the standards for financial statement presentation (especially now that FASB No. 5 is part of our literature) to justify a change in the auditor's reporting on uncertainty.

Time for a Change?

Doug says the time has arrived for us to make a change, i.e., eliminate the use of the "subject to" qualification. In other words, we should limit audit qualifications to those situations where the financial statements fail to conform to generally accepted accounting principles and for conventional scope limitations.

The central recommendations of the paper revolves around two basic issues. They are (1) the benefits of the "subject to" notation to users when the financial statements otherwise disclose material uncertainties and (2) the protection afforded to auditors by the addition of the "subject to" clause in the opinion.

When we look at the developing nature of accounting standards and auditing reporting standards over the last 40 years, there have been sound and understandable reasons for the type of audit reporting which has prevailed. Not only have accounting standards (and the auditor's reporting thereon) been gradually evolving, but the extensiveness of use of financial statements and the expectations of users have increased. The auditor has felt obligated to make up for some of the deficiencies in accounting standards by using the "subject to" and sometimes the "disclaimer" as signals to the reader. Thus for some years the auditor has used these signals whenever it was felt that the financial statements failed to adequately convey the risk situation or that there was a need (and/or expectation) of additional emphasis.

The conditions which gave rise to the use of "subject to" and sometimes the "disclaimer" opinion have been fully explained by Doug. Further, the reasons why we should now move on to a new period in reporting on uncertainty are well documented. Why, then, should we not make this move?

Reader Expectations

Basic to the question of the continued use of the "subject to" opinion is the role (or the perceived role) of the auditor when associated with a firm facing unusual uncertainties and/or serious financial difficulty. Many feel (within and without the profession) that regardless of nice sounding phrases such as "auditing standards," "present fairly," and "conformity with generally accepting ac-

counting principles," if serious or potentially serious financial consequences are looming for the firm under audit, the auditor had better be on record, *up front,* with some appropriate warning. If practitioners perceive that stockholders and creditors (and likely courts and juries, too) expect some explicit warning from the auditor, this constitutes a bias on the part of the auditor which is difficult, in the extreme, to dislodge. The matter becomes not what users and society *should* expect, but rather what many in the profession *perceive* their expectations to be.

We should not overlook the fact that the communication pattern (i.e., the auditor's reporting on unusual uncertainties) has been established and utilized at least since the early 1960's. All the parties to the communication "message" have been conditioned. A change in the form of the message will require re-education. It is certainly difficult in the mass communication arena to change well-ingrained behavior patterns. Are the arguments supporting a change strong enough to justify the efforts?

Other Considerations

On a related point, when the Auditing Standards Executive Committee was considering an SAS on the wording of the standard auditor's report, a decision was made not to change the words "present fairly . . ." but rather to "explain" the *existing* words. There was concern that changing the words would cause excessive complications.

In evaluating Doug's thesis on "subject to" qualifications, we must assess, from a judgmental point of view at least, whether, given the state of the art, we have indeed made sufficient progress in accounting standards and the accounting framework to warrant a change in audit reporting for uncertainties. Doug's paper cites the improvements of FASB No. 5 and other sources such as SEC requirements. His paper also points out that FASB No. 5 does not treat all areas of uncertainties. Maybe the FASB upcoming pronouncement on the conceptual framework will help fill the remaining gaps in our literature. Until we are able to treat uncertainties in a comprehensive manner in the financial statements within accounting standards, should the profession deny the auditor this reporting tool?

On the other hand, if we can conclude that FASB No. 5 has internalized uncertainty (or, at least loss contingencies) within accounting standards, then we can argue that the auditor's role should be to determine that the financial statements conform to accounting standards. This reasoning supports the notion that there is little *added benefit* provided to the reader by the auditor's use of the "subject to" opinion if the uncertainty has been adequately disclosed in the financial statements.

Auditor Protection or Small Comfort?

If, however, the use of the "subject to" opinion cannot be strongly supported on the basis of (added) utility to statement users, does its value as protection to the auditor support its continued use? Doug has pointed out to us that in at least two instances, viz., Talley Industries and Herzfeld vs. LKH & H, the presence of the "subject to," absent what was deemed therein to be adequate disclosure, did not provide much protection to the auditor. However, to most practitioners

there may still be some comfort in being able to point to "something" in the opinion if unfavorable consequences overtake the client.

The great reluctance on the part of practitioners to give up any reporting tools was clearly demonstrated, I believe, in the controversy which preceded the issuance of SAS No. 2 on "Reports on Audited Financial Statements." Much argument and support had developed in the profession and in the Auditing Standards Committee to support the position that there was little benefit to readers or protection to auditors in the use of a "disclaimer" in cases of material (even very material) uncertainties, beyond that which a "subject to" with adequate disclosure could provide. As you may know, the compromise (which was necessary to get a two-thirds vote) was to "permit," although not recommend, the use of "disclaimer" where an auditor felt a need to flash a warning that might have greater impact than that provided by "subject to."

Prognosis

The profession has experienced a period of unprecedented litigation where the tendency has been for auditors to look to all existing professional rules and guidelines as protection and to resist strenuously giving in on any point. Courts and regulatory bodies have stepped in and are defining and redefining professional responsibilities. This environment is not at all conducive to our taking bold, progressive steps in the audit reporting area.

Of great practical significance is the fact that the "subject to" opinion is the one departure from the auditor's unqualified report (other than the consistency exception) which is acceptable to the SEC. It is undoubtedly true, as Doug points out, that this departure is sometimes used when an "except for" may be more appropriate. Nevertheless, the "subject to" opinion has become institutionalized and is used by the auditor whenever it is felt that a signal should be given to the reader, or more likely, whenever it is felt that there is a need for some protection in case of adverse consequences.

In summary, I believe Doug has made a strong case for his proposal. I question whether the time is right from the point of view of practitioners and perhaps even from the point of view of users and regulatory bodies.

I believe progress, such as suggested by Doug, should and will come about. It will simply take longer than some of us may feel it properly should.

5

Status Report on Auditing in the European Community*

Richard L. Kramer
Arthur Andersen & Co., Brussels

My comments will be principally directed towards practice within the European Economic Community (EEC). There are, of course, European countries who are not members of the EEC, but the nine member states of the EEC include Europe's largest economic entities, and the major developments in the accounting scene are taking place within the EEC. That scene is, however, one of deep contrasts, so that endeavoring to comment on any aspect of accounting or auditing within the EEC presents a considerable challenge.

The EEC encompasses the countries of Belgium, Denmark, France, Ireland, Italy, Luxembourg, The Netherlands, United Kingdom, and West Germany. The nine member states have a population of approximately 255 million and a gross national product of approximately $1,000 billion (the United States equivalents being approximately 211 million and $1,400 billion).

Historical Developments

A little history is helpful to put our topic in perspective. Considerable differences in accounting philosophies and practices have always existed among the original six member states. The admission in 1973 of Great Britain and Ireland (who share a substantially common approach) and of Denmark brought yet further and deeper diversities. The expanded EEC then had to resolve not only the differences already present in Continental practices but also to accommodate the very different philosophies and practices held by Great Britain and Ireland.

The result was an encounter which, sparing a blow-by-blow description, has fortunately moved the accounting harmonization process quite clearly in the direction of U.S. practices. This resulted not only from strong recognition of British-Irish practices but also because several member states have taken advantage of the time delay to make needed changes in their own professions and accounting practices. This encouraging progress should *not,* however, lead us to underestimate the magnitude of the harmonization task itself nor the time consuming nature inherent in the process of getting nine sovereign countries to first

* Author's note: For purposes of presentation at this symposium, comparison of the EEC generally was made to U.S. accounting and auditing practices. Such a comparison suffers on two accounts. First, European practices are so diverse that country-by-country analyses and comparisons are really needed to do justice to the subject. Michael Lafferty's recent book *Accounting in Europe* (Woodhead Faulkner Ltd., 1975), is highly recommended for the interested reader. Second, a more correct, but time-consuming and overly ambitious, approach would have been to compare European and U.S. practices to an *international standard.* Hopefully, the worldwide professions, including the U.S., will move in this direction.

agree and then to implement anything which is such a basic part of their political and economic structures.

Accounting harmonization within the EEC has received wide coverage in academic circles within the U.S. in recent years. The discussions have, however, tended to concentrate on accounting principles and reporting philosophies rather than upon auditing. Any meaningful discussion of auditing must first deal with the diverse accounting and reporting environment, after which we can explore the present and prospective auditing scene in more depth.

Major Accounting Differences

Accounting within the EEC is characterized by five important differences compared with the United States:

1. *Public interest* (largely a function of share ownership) in business varies tremendously between countries. In most member states, share ownership is either not extensive or is channeled through banks and other institutions (particularly in Germany) with the result that there is little demand for improved reporting standards. Hitherto, only in the British Isles and The Netherlands has there existed a sufficiently wide public interest in business for it to have an impact on financial reporting.
2. *Company law* in a number of countries, rather than "fairness," dominates financial reporting. In such countries, notably Germany and France, prime importance is attached to conformity of financial statements with the detailed provisions of the law rather than whether such financial statements provide a fair presentation. It is probably only in the British Isles and The Netherlands where "fairness" is at present considered to be the overriding objective in financial reporting.
3. *Tax laws* in certain countries, notably Belgium, France and Germany, have constituted a major obstacle to the development of meaningful financial reporting by requiring that income and expenses be treated the same for both book and tax purposes. Since the objectives of tax legislation and financial reporting frequently diverge, these countries have thus created a seemingly impenetrable barrier to the development of improved accounting standards.
4. *Creditor protection* is emphasized, rather than communicating with shareholders. In Belgium, for example, we observe that unions are working vigorously for adequate disclosure, while management, shareholders, and the financial community are disinterested. This attitude combined with the requirements and economics of the tax laws tends to result in more conservative financial statements and less complete disclosure than might otherwise prevail.
5. The *accounting professions* within the EEC have generally had only a weak to moderate influence in the establishment and development of accounting standards and, until recently, such endeavors were highly diffused.

In such an environment, it is not a surprise that auditing standards and procedures tend to vary from very poor to barely adequate by comparison with generally accepted auditing standards in use in the United States.

Fortunately, the seeds for reform are present in the form of the harmonization of accounting and reporting practices.

Accounting Harmonization

The Treaty of Rome establishing the original EEC provided for the eventual overall harmonization of corporate law within the Community, and to this end the Commission of the European Communities has issued a series of proposed directives. The proposed Fourth Directive, originally issued in 1971, is concerned with the presentation and content of annual financial statements, methods of valuation, and the publication of such financial statements. While it is hard to imagine nine countries with greater differences in their present practices, there is one unique common feature in that each member is charged under the Treaty with responsibility for minimizing these differences. There is thus a driving force behind their efforts which is not generally present in other forms of accounting cooperation. The Fourth Directive has been gestating for over a decade and it is now possible to see the likely content and to envisage its inclusion in the statute books of the member states by approximately 1980.

The underlying philosophy of the revised proposed Fourth Directive may be summarized as follows:

Concept of fairness. The overall concept of "fairness" rather than conformity with the law is to be the cornerstone of financial reporting. This, however, is to be achieved not by establishing detailed accounting rules but by the acceptance of existing practices backed by elaborate disclosures.

Present practice accepted. The proposals are principally based on existing laws, generally accepted accounting principles, and business practices within the Community. This does not mean that new norms have not been established—they have. But it does recognize that some practices (such as the insistence of certain member states that book and tax reporting be in conformity) cannot be overcome through the present legislation.

Prescribed basic principles. In spite of permitting a variety of accounting practices in certain areas, the proposed Directive establishes a number of highly desirable basic reporting standards. For example, depreciation of fixed assets will be required, and the use of hidden reserves to normalize income will be precluded. Although it can be argued that the basic principles represent little more than the lowest common denominator within the EEC, it must be continually emphasized that the EEC, because its accounting and reporting had languished, has had far to travel in recent years and must, therefore, frequently settle for pragmatic, partial advances.

National standards may be established. The proposed Directive permits the application of a variety of accounting principles. In addition, matters not covered may be prescribed by the legislature or, more likely, the professional bodies of the member states. Thus, the more progressive members of the EEC who have already established more ambitious standards or programs than those envisaged by the proposed Directive will generally be free to pursue these programs.

Application is selective. The proposed Directive will apply to all forms of companies that limit the liability of owners for the companies' debts; these types of companies in each of the member states are specified in Article 1 of the

proposed Directive. However, it contains a provision that would authorize member states to permit certain small private companies to publish abridged balance sheet and profit and loss information.

Auditing

With the foregoing background, I can now turn specifically to auditing standards and procedures within the EEC. My comments will be directed mainly to the more significant differences between the EEC and the United States. For this purpose, my comments will refer to the primary headings of generally accepted auditing standards as used in the United States; namely, general standards, standards of field work and standards of reporting. Auditing procedures as distinct from auditing standards are also discussed.

I will then offer some comments on the possible course of future developments.

Because of the many contrasts between member states, an overall comparison between the EEC and the United States becomes complicated. To cut through the diversity, one must concentrate on the factors that are common to a number of the EEC countries that differ from practice in the United States. Therefore, I must generalize and generalizations by their nature will be charitable to some and uncharitable to others.

Accounting and Auditing Contrasted

Probably the most striking difference between the EEC and the United States is the degree to which the development of auditing standards and procedures has lagged behind the development of accounting and reporting standards.

In most member states, auditing standards and procedures are far from maturity and in some member states are hardly embryonic. While differences in accounting and reporting have received much attention in recent years and the proposals for harmonization are at a relatively advanced stage, the establishment of generally accepted auditing standards is really still an embryo. Even in the British Isles, which is generally viewed as the most advanced of the member states, the accounting profession acknowledges it has yet to develop auditing standards and procedures in many areas and has therefore recently announced its intention to devote much greater effort in this area.

This is generally in deep contrast to the situation in the United States, where it has long been recognized that the development of accounting practices and auditing standards must move in unison if the end product is to be improved. Such unison of development has not generally been present in the EEC.

Concept of an Audit

While the accounting professions of most member states aspire to using the basic concepts of auditing accepted in the United States, the laws of certain countries, for example, Belgium and Italy, provide for the appointment of auditors in circumstances which do not even remotely resemble an examination using generally accepted auditing standards. In these countries, it is recognized that the statutory audits required by the law involve little more than a cursory review of the financial statements and that the whole exercise is very perfunctory.

Government Involvement

While the governments of the member states have established the legal framework for auditing by requiring audits of various types of entities, the approach has varied significantly between countries.

One of the most interesting differences is the type of entity that must be audited. Most continental member states began by requiring that only listed companies be audited and then expanded the requirement over the years to other companies meeting certain criteria, generally size. In contrast, the law in the British Isles requires that all companies with limited liability be audited irrespective of size. This means that in the British Isles, over half a million companies are audited annually, theoretically to the same auditing standards since neither the law nor the professional literature recognizes any differences in this regard. However, the profession tacitly recognizes the differences in the auditing procedures it applies and it would appear that legal and professional recognition of the impossibility of auditing all companies to the same standard is a necessary prelude to improvement of auditing standards in the British Isles.

In addition to stipulating the entities to be audited, the governments of most member states have established provisions relating to the qualifications, appointment, responsibilities, etc., of auditors. Although there are many differences, they are not significant to the overall view.

Professional Institutes

While the laws of most member states have provided a legal environment for auditing, the auditing standards to be applied have invariably been left to the respective national professional institutes. The standards established by the professional institutes have hitherto been principally concerned with what are termed "general standards" in the United States. They have thus been primarily concerned with training and proficiency, independence, and related professional matters.

Even in countries where the respective institutes have issued pronouncements on more detailed auditing procedures, the approach has been *ad hoc.* In no country within the EEC does there exist a comprehensive body of published auditing standards building from the general to the particular equivalent to that issued by the American Institute.

Qualifications

Most member states share the philosophy that auditing is a highly responsible activity that should be conducted only by parties who have obtained recognized professional qualifications. With a few exceptions, the obtaining of a professional qualification is essential to a right to practice and the laws of most member states restrict auditing to members of certain recognized professional institutes. Admission to such institutes is invariably by examination, accompanied by varying periods of internship aimed at providing a thorough grounding in accounting and auditing practices before admission. The educational standards necessary to commence training are generally high although a university degree is not universally required. Overall, the professional accountant within the EEC

is generally well prepared to play a more vigorous role as the auditing profession develops.

Independence

While it has generally been recognized that independence is a significant factor, the concept does not have the sanctity it has in the United States. Thus, while it is generally accepted that an auditor may not be an employee of the company and that no member of the auditing firm should participate in the management of the company, there are few rules with regard to share ownership in client companies. Thus, in the British Isles, share ownership by an auditor in a client company, which had been a requirement for appointment, has in the past year been finally officially viewed as an impairment to the independence. The current regulations do, however, provide for a period of transition in which auditors may continue to hold shares in client companies. In Germany, the commercial banks are among the major shareholders of most companies and a number of the major German auditing firms are owned wholly or partly by such commercial banks, thus creating a situation in which the auditor is also a shareholder.

Some examples can be cited in which EEC countries are ahead of the United States. Guidelines in the United Kingdom state that an auditor should derive no more than 15% of total fees from any one client; a guideline basic to independence which the United States could consider importing. Perhaps the U.S. was following a European lead in 1975 when the AICPA announced SAS 7, dealing with communications between predecessor and successor auditors, since the Dutch Institute had established a similar rule of conduct (specifically Rule 29) several years ago. The Dutch rules carefully cover the request of information from the preceding auditors and require receipt of such information (except for unreasonable delays) before acceptance of an appointment. Perhaps this is one of the major reasons why the Dutch profession has such stature, and members of the profession have such strong, yet independent, relationships with their clients.

Standards of Reporting

Standards of reporting in terms of expressing an opinion with regard to adherence to generally accepted accounting principles, the adequacy of informative disclosures and the overall "fairness" of the financial statements, present many contrasts with practice in the United States.

As we have seen, there are at present few *generally accepted accounting principles* recognized in all countries within the EEC, and two member states, notably Belgium and Italy, are virtually without any established accounting principles. Although this situation is in the process of change through the legislative efforts of the European Commission, the final directive will provide for no more than certain basic ingredients for financial statements. Accounting principles will still vary substantially between countries for the foreseeable future; in fact, the differences appear to be growing. Most Continental countries continue to be wedded to cost while the British Isles is moving rapidly towards value-based financial statements. (Of course, my friends in The Netherlands quickly point out that the introduction of replacement value accounting dates back to 1924;

however, there is by no means widespread application and no observable trend to extensive usage such as exists today in the British Isles.)

Thus, an intelligent reading of financial statements from within the EEC demands a thorough knowledge of the accounting principles pertaining in a particular member state. However, even with such knowledge one is not necessarily fully equipped, in that no member state has developed a body of generally accepted accounting principles which approach those in existence in the United States. The absence of generally accepted principles in many areas combined with an acknowledged reticence toward disclosure in many member states, frequently leaves many unanswered questions concerning financial statements.

Turning to the *adequacy of disclosures,* we have seen that conformity with the law continues to be the benchmark for financial statements in certain states. Even where "fairness" is an acknowledged objective, the law has continued to play a significant role in financial statements. For example, while "fairness" may be considered the overriding criterion for financial statements in the British Isles, companies and the accounting profession have been slow to expand disclosures beyond those required by the law. Thus, information relating to such matters as pension costs, leasing obligations, and related party transactions are rarely covered in financial statements in the British Isles. Overall, in the EEC the adequacy of informative disclosures falls far short of present standards in the United States.

With regard to *auditors' reports,* we have seen that the range is from the concept of conformity with the law (as in Germany) to one of "fairness" (as in the British Isles and The Netherlands). A number of states specify additional matters that must be included in auditors' reports, but these are not significant to an understanding of overall standards.

Auditing Procedures

Detailed auditing procedures within the EEC are almost unbelievably varied and hence generalizations are particularly difficult.

Generally, there is much less emphasis on what is termed in the United States "competent evidential matter." While some independent corroborative procedures are followed, they tend to be limited. Circularization of receivables has been endorsed by the professions in the British Isles, Germany, France, and The Netherlands as has the observation of physical inventories. Accounts payable are not generally circularized and the obtaining of legal representations is rare.

Even greater differences are created by the fact that professional endorsement of a procedure does not necessarily mean it is universally followed since professional pronouncements in auditing are generally no more than recommendations and compliance is not mandatory. Thus, while the confirmation of receivables and the observation of physical inventories are recommended by the professions in the British Isles, France, and Germany, such procedures are by no means universally followed in those countries.

It should be noted that in many respects auditing is a relatively new science in certain member states. For instance, in France prior to 1966 only listed companies had to be audited and the most that other companies received was a cursory review. Thus, the present Commissaires aux Comptes are very much in the early

stages of developing and implementing procedures that approach generally accepted standards in the more advanced member states. Actual practice in France is still far behind the professional pronouncements. An even more embryonic situation prevails in Belgium and Italy. In these countries, significant improvements will require a generation to change significantly, which requires a time consuming educational process.

What of the Future?

My comments so far have painted a picture of somewhat backward auditing practices in the EEC. On a positive note, recent years have seen the establishment of the foundations that should provide a base on which to elevate auditing standards, and it is clear that there is a growing awakening to this problem. Generally, the accounting professions within the member states are increasingly well-equipped to elevate their standards. Further significant developments in the area of auditing will undoubtedly take place in the coming years and I will mention the more significant likely developments.

In this connection, I have emphasized the magnitude of the task facing our European contemporaries. When we consider the energy, devotion, and traumas, that have accompanied some of the major auditing developments in the United States, the prospect of conducting the same exercise with the representatives from nine different member states with deeply rooted traditions, practices, etc., presents a task that is, to say the least, formidable. Great credit is due to our European contemporaries for undertaking this endeavor and for the efforts that have and will be made. My feeling is one of guarded optimism about the probable outcome.

What has to be done? In summary, the effort hitherto brought to accounting by member states and combined institutions now needs to be mirrored by similar efforts in auditing. Without such redirection, financial statements may look fine but whether they are right will remain questionable.

Fourth Directive

The Fourth Directive has now received a second reading by the Council of Ministers working party and will probably be enacted by the Council within the next year. The enactment of the Fourth Directive by the Council will require each member state to incorporate its provisions into its national laws within a period of 30 months. The enactment of the Fourth Directive will, I suspect, act as a sort of watershed for progress within the EEC. The professions will realize how much has been achieved and begin to see the potential for further progress.

Fifth Directive

The Fifth Directive on the Structure of Sociétés Anonymes (1972) contained a number of important measures with regard to auditors. The proposed directive would apply to each company that is organized under the law of a member state as a *société anonyme,* which term is used to describe a corporation whose capital is represented by freely transferable shares and whose shareholders have no personal liability to creditors beyond the amount of unpaid subscriptions for shares. Among the more important provisions concerning auditors are the provisions concerning the independence of auditors and the appointment of auditors.

A person would not be eligible to become the auditor of a company if then or during the last three years the person was a member of the company's supervisory board, management board, or staff. Similar restrictions would apply to an enterprise or firm if any member or partner in the firm or member of its supervisory or management board or person having power to represent the firm is or during the past three years was a member of the company's supervisory board, management board, or staff. Auditors would be appointed for a specified period, which would have to be at least 3 and not more than 6 years although auditors would be eligible to be reappointed to successive terms.

While the provisions of the Fifth Directive relating to auditors will undoubtedly find their way to the statute book eventually, the overall Directive contains many contentious matters with regard to worker participation in management and it may be necessary to present the provisions relating to auditors in a new document.

National Progress

The gradual integration of many EEC institutions and the advent of a single capital market is likely to provide a tremendous impetus to certain national laggards. In other words, the example being set in certain member states will undoubtedly be emulated by others. The changes that have occurred in France in the last decade illustrate the sort of development that is likely to evolve in other member states.

However, leaving developments to individual member states may result in slow and fortuitous progress and it seems likely that substantive progress will only be made through the combined efforts of the member states.

International Development

As in the United States, governments appear content to leave the logistical aspects of auditing to the accounting professions—provided, of course, satisfactory progress is made. Accordingly, responsibility for raising auditing standards presently rests squarely with the professions.

A number of organizations presently exist which could act as a catalyst to improve auditing standards. The Union Européenne des Experts Comptables Economiques et Financiers (the "UEC") and the EEC Accountants Study Group (the "Study Group") would be the natural forums. The UEC, which is an international organization embracing virtually all the European countries, has already issued some statements on auditing but they have been relatively low key and are no more than recommendations. Accordingly, a much more likely forum is the Study Group.

The Study Group comprises representatives of the professional bodies of the member states. For a number of years, the Study Group has assisted the European Commission in the study and development of accounting, and it has become recognized as the principal body with which the Commission and its various agencies consult on accounting matters. The Study Group has played an active role in the development of the Fourth Directive but hitherto its efforts have been largely confined to accounting principles and reporting practices. As I have illustrated, there is an urgent need within the EEC for the harmonization of

accounting and reporting practices, to be followed by the harmonization and elevation of auditing standards. This will require the combined efforts of the professional institutes of the various member states and I believe that it is inevitable that the Study Group or similar body will be charged with the harmonization of auditing standards. Exactly how this will be achieved is unknown. However, countries are presently cooperating in accounting and reporting matters in a manner which was almost inconceivable only a few years ago, and it is clear that such study and eventual harmonization must, of necessity, reach auditing standards and procedures.

Value Reporting

No current commentary on the accounting scene within the EEC would be complete without mention of the move towards value orientated reporting in the British Isles. Following the issue of the Sandilands Committee recommendations last year, the accounting profession is now rapidly developing the disciplines necessary to implement a system known as Current Cost Accounting (CCA). This system will report fixed assets and inventories at current value and also report the impact of inflation on reported results. The end product is a system very similar to that set forth in the Arthur Andersen & Co. publication *Accounting Standards for Business Enterprises Throughout the World.*

The significance of value reporting to auditing lies in the fact that it demands a significant change in mentality on the part of the auditor. The auditor is charged with reporting on amounts which are highly relevant but not necessarily subject to the precise determination that has been possible under the historical cost system. This will, of course, inject greater subjectivity into the role of the auditor and as a result, demand much greater judgment and caution.

Auditors' Liability

And now to end on a lighter note. One significant memorandum issued by the Study Group in 1974 concerned the liability of auditors. It clearly reflects recognition that with progress will come responsibilities that must be defined and limited. The principal recommendations and conclusions contained in the memorandum were that:

1. Any damage arising from reliance placed on a company's annual financial statements that do not present a true and fair view should be primarily the responsibility of the company's management board.
2. Legal liability proceedings should be brought against auditors only after all recourse against members of the management board relating to the statements has been exhausted.
3. Because all auditors in member states do not have professional liability insurance, the present unlimited liability of auditors in certain member states offers false security in that compensation frequently cannot be made beyond the means of the auditor and thus the right to unlimited damages is purely theoretical. Accordingly, it is proposed that in any case of civil liability, where the wrongful act was not committed intentionally:

a) any loss that is estimated at an amount of approximately $100,000 or less, must be made good in full, and
b) any loss of a higher amount shall be made good up to an amount equal to ten times the annual audit fee relating to the accounts in question or an amount of approximately $1,000,000, whichever is less.

4. Professional insurance up to the recommended maximum liability amounts should be made obligatory.

In the light of experience in the United States, our contemporaries within the EEC may have many shortcomings, but they most certainly have communicated the message loud and clear with regard to reasonably limiting their obligation.

This is but one example of an area where the U.S. may have much to learn—that of working out an effective, constructive working relationship between government and the profession. This may, in fact, be one of the main reasons for the U.S. to take increased interest in future EEC developments. If the past few years are any guide, the EEC countries will increasingly encounter terrain familiar to the United States, and their highly pragmatic solutions may increasingly provide comparisons and contrasts to be studied, and additional lessons to be learned.

Discussant's Response to Status Report on Auditing in the European Community

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The task of preparing a report on the status of auditing in a single country is a difficult one because of the many auditing aspects involved; preparing a status report on auditing in nine countries is even more difficult because of the differences among the countries. Taking this into account, Richard Kramer's report gives a clear analysis of the current accounting and auditing situation.

I will not focus my discussion on the description of the current situation as such, but try to add some aspects that are relevant for an evaluation of that situation and for formulating expectations.

I will cover mainly three topics:

(a) The evaluation criteria used to analyze the status of auditing.
(b) The current status and future expectations about accounting.
(c) The current status and expectations concerning the future of auditing.

Evaluation Criteria

The problem of using appropriate criteria is probably the most difficult problem that one faces in evaluating the current status, since the outcome of the evaluation is very much dependent upon these criteria.

The author compares the situation of the EEC *as a whole* with that of the U.S., taking in most instances the American situation as a standard. It is undoubtedly interesting for U.S. accountants and auditors to compare their situation with the European situation. Unfortunately, however, this method of comparison obscures the fact that the EEC is so different from the U.S. that the two cannot realistically be compared.

First, the EEC consists of nine different states, each one having its own economic, political, and social system. To consider the EEC as a whole is at the present time only justified in the areas of agricultural and trade policy. The corporations in each of the member states are mainly operated under company laws, which are different in each state. There is not yet a European company operating under EEC rules.

A unified European capital market, in the sense that banking systems, stock exchanges, etc., are integrated, does not exist. Although there are, of course, in the EEC a number of multi-national corporations, the capital sources, ownership, and employees for most companies are concentrated in the countries where the companies have their main operations. So the financial statements and the attached auditing reports are mainly only of importance within each country.

Auditing work is done in each country according to national standards. The educational system in each country has the purpose of providing the required knowledge for an auditor to operate at a national level. Generally state laws require certain corporations to be audited, and at the same time set requirements for the auditor's qualifications. Foreign accountants are generally allowed to audit those corporations only if they have the same qualifications as national accountants.

The foregoing means that in each country auditing is mainly of national importance, and it has some specified meaning which is recognized within each country. Therefore, the status of auditing and accounting would be better judged by taking into account the national circumstances. In other words, the evaluation criterion could be: Do auditing and accounting, under the national political, economic, and social circumstances of a certain country, perform their functions well?

This statement of the problem does not take into account that there is a tendency toward economic, political, and social integration. But for the moment, this integration is not at all realized. Therefore, it is in my opinion that it is better to discuss this as a prospective issue, although this perspective clearly requires very important changes.

Accounting: The Current Situation and the Future

The author mentions five points, describing differences between accounting in the EEC and in the U.S. Some of these points are probably connected. Thus, if shareholdership is less important, it is to be expected that creditor protection receives more emphasis. Then too, it should be added that the interests of employees tend to become an increasingly important factor that should be taken into account.

Government involvement in setting rules for financial reporting is probably connected with the degree of freedom for national accounting professions to set accounting standards. With the author, I believe that too much government involvement can be a hindrance to prepare meaningful and fair financial statements, but on the other hand, if certain laws exist which prescribe certain strict rules, their appropriate evaluation criterion is whether or not those rules are good, taking into account the purposes and uses of financial statements in those countries. Especially since the investing public is less important in the EEC than in the U.S. and other groups are more important as users of the services of auditors and accountants, U.S. criteria are not valid in judging the adequacy of disclosure and valuation in the EEC.

From this viewpoint, undoubtedly, the situation in certain countries is not optimal (especially not in Italy). Additionally, tax laws requiring certain treatments of income determination in the financial statements can be obstacles to improvement of accounting standards, as Kramer has indicated.

The prospects for harmonization are, however, clearly laid down in the Fourth Directive of the European Community. Its second draft is influenced by the accounting profession, via the EEC Accountants' Study Group. This proposal is a basis for future development by means of its design. It is mainly directed toward disclosure, but it allows flexibility. However, it is still unclear to what extent there will be room for accounting standards, although it can be expected

that these will to some extent be proposed on an EEC level. The resulting system is not likely to be as extensive as the U.S. system of generally accepted accounting principles, and it will also be considerably more flexible.

As long as the economic and political integration is still in *statue nascendi,* it is in my opinion not a disadvantage that there remains some room for national financial reporting differences. The trend towards value accounting in the British Isles is very much comparable to the trend in the Netherlands, where we clearly see a tendency to show both historical cost and replacement cost-based profit caclulations. This tendency is also present in Germany where the Accountants Institute recommended that financial statements should show the effect on profit of price changes of assets consumed in sales, as far as they were financed by stockholders' equity.

Auditing: Present and Future

The paper presents the following picture of the current situation:

(a) Auditing standards are different in the member states and are in some countries even absent.
(b) Standards of reporting are less developed.
(c) Auditing procedures are less stringently prescribed than they are in the U.S.

The auditing standards in each country are a reflection of the concept of auditing prevalent in that member state. The differences among the states can probably be expressed in the following generalizations. As far as the examination of the accounting system is concerned, there is a distinction between professions emphasizing the formal correctness of the books and those emphasizing auditing techniques that are more directed to problems of insuring that all the economic activities of a firm are properly reported. In the area of financial reporting, a distinction might be made between emphasis on legal requirements and emphasis on the adequacy of financial statements in providing information.

To appraise the situation properly, pronouncements on auditing standards need not necessarily be considered to be a good source, since at least in some countries they are only a reflection of generally accepted standards that are already operational. However, many firms apply their own, more detailed standards, and in some countries courts take jurisdiction on behalf of the profession to make certain that auditing practice is appropriate in the circumstances. So at least a partial explanation for the absence of stringent auditing standards is an individualistic attitude among auditors which emphasizes the choice of the appropriate techniques for each company. It might be expected that the above mentioned differences in approach towards auditing will make it very difficult to develop uniform auditing in the EEC.

An additional point is that auditing education is very different in many respects. In some countries universities are the main educational institutions, while in other countries, apprenticeship systems prevail. Harmonization of auditing education is an especially important requirement to develop a harmonized auditing practice in the future. In the current situation in each country there is a tendency to teach students the auditing approach that is prevalent in that

country. In the future, it will be very important to take a broader point of view, and that will require that standards are developed at an EEC level that define the concept of auditing.

Even when those standards are developed, the implementation in practice will take some time, since resistance to change will hinder auditors in many countries from changing their approach. In this area, there is certainly a big task for the EEC.

Finally, we should perhaps mention that many public accounting firms in the EEC have recently established relationships with firms in other EEC countries. This enables a mutual influence and can be a very important factor in harmonizing auditing standards.

In conclusion, it might be said that my opinion is different from Richard Kramer's at the following points:

(a) In his evaluation, he takes largely the U.S. situation as a starting point and compares it with the EEC *as a whole*. I would prefer an approach that analyzes the situation in each country, taking into account the legal, economic, and social framework of the country.

(b) I have a more positive attitude towards the accounting harmonization proposals of the EEC.

(c) I think that auditing standards for the EEC *as a whole* in the future will be necessary, but in the current situation where (and if) the financial statements have only national significance, the lack of uniform standards is not as bad as Kramer suggests.

(d) The lack of explicit standards in some countries is partly due to an individualistic approach towards auditing, and does not mean that no standards exist, but rather that they (especially standards of fieldwork) are set for each individual case relative to the needs and relationships that have been discerned.

(e) It will be difficult to harmonize auditing in the future because of differences in auditing approaches. In this regard, as differences in auditing education among countries are overcome, change will be facilitated, but international cooperation on many levels will always be important.

6

An Examination of the Status of Probability Sampling in the Courts

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Auditing researchers, staggering under an ever-increasing blizzard of pronouncements, articles, and memoranda, might well be disposed to believe that complexity feeds on itself. For example, two themes which were of much concern—perhaps even dominant—at the first two University of Kansas Auditing Symposia[1] were the increase in litigation against auditors and the growing sophistication of statistical sampling techniques in auditing. This paper attempts to examine the interaction between the two.

Indeed, his paper arose directly as a result of the 1974 Symposium. At that conference, one of the present authors raised the question of whether statistical sampling (i.e., probability sampling) would be a better defense in the courts than judgment sampling. There appeared to be some division among practitioners present at the conference.

Practitioner Opinions

Some felt that the use of probability sampling would ameliorate the position of the defense in a lawsuit, since probability sampling is viewed as more "scientific," as encompassing more up-to-date technology, and as more susceptible to mathematical "proof" of its validity.

Others were more skeptical or at least agnostic. They felt that expert witnesses might debate the merits of *a particular* probability sampling plan to the ultimate utter confusion of jurors and jurists. Their contention was that the "expert judgment" of a highly trained professional, on the other hand, was less suspect and less susceptible to point-by-point rebuttal.

Our purpose in this paper is twofold. First, we will examine past court decisions to discover whether the courts have shown any preference for probability sampling. Then we will examine cases in which probability sampling was used, either by one of the parties or by the courts themselves, to see what implicit standards for such sampling may be emerging from the judicial process.

For readers who are curious about the outcome of these questions, yet less than enthusiastic about wading through the details of this paper, we will admit at the outset that our conclusions are more equivocal and more tentative than

either they or we might have wished. Auditing remains an inappropriate field for uncertainty-avoiders!

Some Definitions

Probability sampling plans, to quote one source implicitly used by the courts, ". . . make use of the theory of probability to combine a suitable procedure for selecting sample items with an appropriate procedure for summarizing the test results so the inferences may be drawn and risks calculated from the test results by the theory of probability. For any given set of conditions there will usually be several possible plans, all valid, but differing in speed, simplicity, and cost."[2] Simple random sampling is but one of many possible applications of probability sampling.

Judgment (non-random) sampling plans, on the other hand, ". . . have one common characteristic: the probability that an individual (item) is included in the sample is unknown. . . . When the determination of the individuals (items) to be included in a sample involves personal judgment, one cannot have an objective measure of the reliability of the sample results, because the various individuals (items) may have differing and unknown chances of being drawn."[3]

A *census* involves the examination of all items in a population, rather than a sample thereof. The economics and timing of such procedures preclude their use for more facets of an audit.

Extent of Use of Probability Sampling

The official policy of the AICPA has been to condone both probability and judgment sampling.[4] An examination that we made of a (non-random) sample of six recent auditing textbooks indicated that judgment sampling was not explicitly condemned, but the preponderance of material under the heading "sampling" dealt with probability sampling.

Most accredited Schools of Business have required one or more courses in statistical theory and techniques for at least the past decade or two. All national CPA firms and the AICPA have offered training programs or modules on probability sampling as well. One might expect, then, that probability sampling is used overwhelming. This is apparently not the case, however.

A questionnaire survey by Jacobs[5] of CPA firms in the Los Angeles area revealed a wide disparity in the use of statistical sampling within a given office, among firms of a given size, and among firms of differing sizes. As might have been expected, the use of statistical sampling by national firms was far greater than by locals, but the use was far from universal in any size grouping.

A more extensive questionnaire survey, undertaken by Strawser and Hubbard[6] confirmed these findings; their research also indicated that utilization of statistical sampling techniques has been increasing fairly rapidly in recent years. These results were consistent with an unscientific face-to-face inquiry of various Portland, Oregon practitioners undertaken by one of the present authors during the past year.

Judgment sampling, then, is still very much alive, and its acceptability in the courts is thus not a trivial problem.

Survey of Cases

We surveyed a wide variety of cases where statistical sampling was an explicit issue or in which it was mentioned by the courts. We wish that we could report that we found *The Definitive Audit Case* or a truly helpful case of any kind. Instead, we found that references to sampling usually arose where the technique was being used to gather evidence for the court, rather than where it had been used prior to the litigation, such as in an auditor's test of transactions. Therefore, we concentrated on court pronouncements that suggested standards that *should be used* in sampling. Such standards, we argued, should be applicable in almost any context, and in particular where an auditor's use of a sampling method might be questioned relative to the standards recognized by the courts.

Implicit Court Standards for Sampling in General

There is no codified law regarding standards for sampling. Yet standards of other bodies, while not of themselves court standards, become so indirectly when they are recognized and cited as such by the courts on sufficient occasions.

"Handbook of Recommended Procedures for the Trial of Protracted Cases" is a Report of the Judicial Conference Study Group on Procedure in Protracted Litigation. This report was adopted by the Judicial Conference of the United States in March, 1960. It reached the following conclusions on the question of sampling:

> Scientifically designed samples and polls have received increasing acceptance in recent years in government and in industry. The important question to be considered in a given case is whether the contemplated or proffered sample or poll is admissible under existing rules of evidence.
>
> Samples [confined to observable facts]. When a sample is offered through the testimony of the sampler, the report on the sample examined (i.e., on the count of units or the test borings, in the samples noted above) usually does not involve hearsay. In order to project this report, however, the burden of proof rests upon the offeror to show, by the testimony of a statistical expert, that the sample was selected in accordance with accepted principles of sampling so that it properly represents the universe. *Note.* Once this is established, there remain only questions of relevancy, materiality and weight.[7]

The note in the above quote refers to two sources of accepted principles of sampling. They are:

1. Munitions Board Standards, Agency of the Department of Defense, and
2. The American Society for Testing and Materials.

We were unable to locate the Munitions Board Standards, but we did examine the relevant standards of The American Society for Testing and Materials (ASTM) in some detail.[8]

A perusal of ASTM's standards for statistical sampling reveal—by the sophisticated nature of the language, mathematical notation, and footnote references—that these standards were enacted by statisticians for use by those with considerable grounding in the field of probability and statistics.

ASTM's pronouncements also reveal, time and again, a pronounced preference

for probability sampling and an aversion to wholesale nonrandom sampling. For instance:

> In order to make any estimate for a lot or for a process, on the basis of a sample, it is necessary to select the units in the sample at random. . . . The only universally acceptable definition of a random selection is is one made by the use of random numbers, which in effect is the guarantee of thorough stirring of the sampling units in a lot.[9]
>
> Selection by use of random numbers need not be more onerous or costly than hit-or-miss methods of sample selection, provided the sampling plan is thoughtfully formulated. . . . Randomness is obtained by positive action; a random selection is not merely a haphazard selection, nor one declared to be without bias. . . . However, mechanical selection is still usually preferable to a judgment-selection.[10]
>
> The foregoing paragraphs do not mean that nonrandom and judgment samples, for example, may provide useful information for the efficient design of a probability sampling plan. . . . It also should be noted that judgment plays an important role in the *design* of a probability sampling plan. For example, it may be used to assess costs, to estimate spreads and likely values of variances; also definitions of strata. In the actual probability sample, however, judgment is not used in the selection of the individual items of the sample, nor in making the inferences, nor in calculating the risks of decisions based wholly on the sample or succession of samples.[11]

Thus, nonrandom sampling is relegated by ASTM to a role of amassing initial evidence when little is known about the underlying population. Such might be the case in a preliminary stage of an audit of a previously unaudited client, for instance, but would not likely be the case in the *actual selection* of receivables to be confirmed for the engagement, and especially would not be supportable for an engagement that has been of long standing.

The courts have cited the Handbook, and thus implicitly the ASTM standards, on at least three occasions. None involved auditing, however, and none involved a head-on-head confrontation between probability and judgment sampling.

In *Bank of Utah v. Commercial Security Bank*,[12] the courts rejected plaintiff's sampling plan in an action under the Sherman Act for treble damages and injunctive relief. The court held that the restraint involved in a "no check" plan whereby school employees were required to take some affirmative action to transfer funds from defendant bank to a bank of the employee's choice was not shown to be unreasonable.

> . . . (T)he tendency is to admit the results of properly conducted surveys for whatever they are worth in spite of the hearsay difficulty. . . . In this case, however, we do not even reach the hearsay question as it relates to the admissibility of surveys, for we think the trial court was well within its bounds of discretion in refusing to admit a poll conducted as was this one.
>
> A survey is inadmissible when the sample is clearly not representative of the universe it is intended to reflect. See Hawley Products C. v. United States Trunk Co., 1 Cir., 259 F. 2d 69, 77; Handbook of Recommended Procedures for the Trial of Protracted Cases, 25 F.R.D. 351,429; . . . Here the universe was either all school board and hospital employees under the

plan, or at a minimum all school board employees under the plan. The sample was chosen from neither of these groups but instead from those employees who at one time banked with appellants and later switched exclusively to Commercial Security.[13]

In another case, *Berman v. New Hampshire Jockey Club, Inc.*,[14] the court rejected a poll as evidence, citing the Handbook, and finding the poll to be entirely inadequate. One reason was because the sample size was less than 1% of a universe of 3,500 to 5,000. It is of interest that the ASTM standards include a section replete with mathematical notation entitled "Equations for Calculating Sample Size," with the strong implicit assumption that probability sampling is used and that characteristics of the underlying probability distribution are known or can be estimated.[15]

In a third case in which the Handbook was cited by the court, *Grotrian, Helfferich, Schuz, etc. v. Steinway and Sons*,[16] the court held that the survey offered in evidence met the criteria for admissibility of samples found in the Handbook.

Court's Examination of Underlying Probability Distribution

The underlying probability distribution on which a sampling plan was based arose in two cases involving depreciation, both, however, concerned tax litigation, not financial auditing.

In *Commissioner v. Indiana Broadcasting Corp.*,[17] the question was whether a television network affiliation for a two-year term, which is automatically renewable in the absence of termination by the affirmative act of either of the parties, for an unlimited number of successive two-year terms, is a depreciable asset. The Seventh Circuit Court held that it was not a depreciable asset.

> The theory of the statistical tables compiled was that an annual rate of contract termination for each pertinent period could be obtained by dividing the total number of years commenced by all the affiliation contracts during a given period into the total number of contract terminations occurring during the same period. Using that termination rate, taxpayer's expert witnesses testified that the average life expectancy of any given contract could be determined by applying the Poisson-Exponential Theory of Failure. The crux of that theory is that the percentage of failure of items to which it is applied is a constant. . . .
>
> Adopting that theory, and applying it with some modification to the statistical history, the Tax Court found that an estimated useful life of the WISH and WANE CBA affiliation contracts could be determined with reasonable accuracy, and that use of a straight-line method over 20 years was a reasonable basis for depreciation of the contracts.
>
> We think the Tax Court erred. . . .[18]
>
> It is likewise clear that the stipulated exhibit graphically refutes the existence of a basic premise upon which the Poisson Theory relies, namely, that the life expectancy of all contracts is the same regardless of the length of duration of the contract.[19]

Super Foods Services, Inc. v. United States[20] is similar to *Indiana Broadcasting*. Super Foods owned franchise contracts with grocers; they attempted to depreciate the contracts, but the IRS claimed that the contracts had indefinite

lives. The plantiff introduced a study of 486 contracts; the study tended to show that any contract which had been in force more than 12 months had an average life of 86 months. Expert testimony was that the contracts "display a definite and consistent pattern of termination." The government relied on *Indiana Broadcasting* for the proposition that statistics of past performance do not reliably predict termination dates. In ruling for the taxpayer, the court distinguished *Indiana Broadcasting* because in the present case the IRS had introduced no evidence of their own to controvert plaintiff's statistical evidence.

Court's Examinaion of Sampling Plan Used by Litigant

Johnson v. White[21] was an action by Connecticut welfare recipients against the state commissioner of welfare. The commissioner had converted the FADC program to a "flat grant" system to simplify AFDC payments by averaging budgeted needs of each size of assistance unit and making identical payments to each family of a given size. The court held that such averaging was permissible, and explained:

> The defendant adopted a pre-sample confidence interval of 95%, plus or minus 10%; and a post-sample check determined that the selected level of confidence had in fact been met. The defendant's sampling technique was approved by HEW. The plaintiff's claim that in certain components of need for certain assistance unit sizes, the sample size was too small to guarantee the selected level of confidence. The defendant's confidence level, however, was for the average of budgeted needs as a whole, rather than for each component in the standard of need. Giving due weight to the expert opinion of HEW, the court finds that the defendant's sampling technique was adequate.[22]

Use of Sampling Techniques by Court Itself

In *Rosado v. Wyman*,[23] also a welfare case, New York welfare recipients claimed that the state impermissibly lowered the standard of need by eliminating items arbitrarily in 1970. Social Security Act Sec. 402 (a) (23) provides that a state may not lower its standard of need by arbitrarily eliminating items which were included before enactment of the amended statue in 1969.

The court used statistical sampling techniques to determine if amounts paid under the 1970 plan accounted for certain special need grants paid in 1968. The amount of aid received by a sample of 1968 recipients was compared to the proposed 1970 schedule. The court found that 1968 recipients received more than was allowed by the 1970 schedule, refuting New York's allegation of paying 100% of the standard of need in both years.

Some Other Illustrative Cases

Many anti-trust cases employ statistics. In bank merger cases, such as *United States v. Philadelphia National Bank*[24] and *United States v. Manufacturers Hanover Trust Co.*,[25] the government used rather simple arithmetical statistics to show the effect of mergers. For a detailed analysis of these two cases, and—in particular—for suggestions for the use of statistics in similar cases, see Lozowick et al.[26]

An older case involving statistics, a landmark anti-trust action, was *United States v. United Shoe Machinery*.[27] The court discussed minor problems with the government's choice of universe and of sample selection, but accepted the sample pragmatically, because ". . . if anti-trust trials are to be kept manageable, samples must be used, and a sample which is in general reasonable should not be rejected in the absence of an offer of a better sample."[28]

In *Hawley Products Co. v. United States Trunk Co.*[29] (a case, incidentally, cited by the court in *Bank of Utah v. Commercial Security Bank*, which we discussed earlier) and in a related case, *American Luggage Works, v. United States Trunk Co.*,[30] plaintiff attempted to prove that its design for suitcases had acquired a secondary meaning. The survey was "inadmissible to show that in the market of ultimate consumers the plaintiff's design had acquired a secondary meaning when the universe surveyed consisted of retailers."[31]

In *International Milling Co. v. Robin Hood Popcorn Co.*,[32] the evidence included a consumer action survey designed to determine whether purchasers associated the product packaged by International Milling with the product packaged by Robin Hood. The Commission went into detail in describing the survey, the questions asked, the selection of a sample and the standard deviation expected.

Readers may be familiar with the use of sampling in cases where a defendant or plaintiff has asserted that a jury is racially imbalanced and thus in violation of Fourteenth Amendment rights. In cases such as *Carter v. Jury Commission*,[33] courts have been willing to accept a statistical analysis of the population and use that probability to determine that a certain proportion of jurors should be of a particular race. (Such cases, of course, involve arguments from the population, rather than from a sample.) A recent article on jury selection goes into detail on the statistical problems involved.[34]

Sampling Standards Employed by Internal Revenue Service

The IRS issued some rather lengthy standards of sampling in conjunction with the timing of trading stamp redemptions. These standards explicitly condone only *probability* sampling. Thus, "the taxpayer may use any sampling procedures that are in accord with generally accepted probability sampling techniques. . . . While no specific requirements are established for the sampling expert responsible for the design of the study, it is recognized probability sampling is a highly specialized field and that otherwise competent statisticians may not be qualified in the field of probability sampling. . . . The sampling plan which is used must conform to the standards of the 'Report of Committee on Standards of Probability Sampling for Legal Evidence—Admissibility of Data from Probability Samples.' "[35]

This report, published by the Society of Business Advisory Professions, Inc., in cooperation with New York University, is remarkably similar in tone and substance to the previously cited ASTM documents. The report does not allow for the possibility of judgment sampling, and indeed makes the solemn assertion (in two different places) that: "The interpretation of a statistical calculation such as the standard error is not a matter of opinion, nor of judgment, but is a mathematical consequence."[36]

Approval of Probability Sampling by U.S. Congress

In a bill approved in 1964, the House of Representatives specifically permitted the use of statistical sampling procedures in the examination of vouchers. A detailed report accompanying the bill discusses the appropriate use of statistical sampling in the examination of vouchers and the reasons supporting increased governmental adoption of statistical analysis.[37]

A Most Tentative Conclusion

No absolutely definitive case has yet arisen to demonstrate that judgment sampling will not be allowed by the courts in auditing. Nonetheless, some trends seem apparent to us. The courts—and such quasi-judicial agencies as IRS—are relying more heavily on sophisticated statistical documents whose standards barely condone, and certainly do not encourage, nonrandom sampling *when probability sampling is feasible.*

We can not conclude with the lame epithet that "further research needs to be done." There is no more "data" left to examine, and additional "research" will be effected by the courts themselves. Our murky crystal ball suggests that a landmark case involving sampling in an auditing context will arise within the next few years. We caution those auditors who continue to use judgment sampling in the presence of feasible probability sampling procedures to be prepared to defend their logic in so doing. For that matter, given some of the decisions cited, we urge auditors who use probability sampling to be prepared to defend their particular sampling plans in terms of demonstrating that their sample results can indeed be argued to be representative of the underlying universe.

Addendum: Sampling Lost, Sampling Vindicated?

The following case has been verbally cited to us by several colleagues. So far as we know, it has not been officially reported. Moreover, it is somewhat dated and was tried on a municipal court level only. Nonetheless, for the sake of completeness, we include it for the interested reader.

In Sears Roebuck and Co. vs. the City of Inglewood,[38] Sears sued for a sales tax refund of $27,000. Sears had found an error in their own local records as to the extent of out-of-city sales, such sales not being subject to the municipal tax. In support of their contention, Sears conducted a random sample of sales slips, which indicated that the refund ought to be $28,250, plus or minus $4,200, at a 95% confidence interval.

The judge ruled against *any* sampling technique! This ruling was not predicated on any statistical oversight in Sears's procedures, but on the judge's contention that the amount of the refund must be determined exactly, without *any* possible error in estimation, however small. That is, he insisted, as required by the applicable statute, that Sears demonstrate a lack of sales tax liability for each invoice!

Since the Court permitted Sears to perform a "complete audit," the plaintiff did not appeal the case. The complete audit, of which the sample had constituted only 4%, revealed a liability of $26,750.22, well within the confidence interval.

As we said, we doubt that this case constitutes an important precedent, since

special conditions were present which the judge interpreted to preclude *any* form of sampling. If sampling *is* applicable, judges can be expected to follow the precedents that have been cited, and even if a judge does not understand all of the ramifications of sampling, sampling is at least likely to be tolerated.

It is of interest, however, that the author who cites this case goes on to comment, hypothetically, ". . . if (the judge) had refused to admit the amount of the claim as $27,000 because it was based on a *judgment sample* as opposed to the random sampling insisted on here, that also would have been a valid objection."[39]

Footnotes

1. Howard Stettler, Editor, *Auditing Looks Ahead,* University of Kansas School of Business, 1972, and *Contemporary Auditing Problems,* University of Kansas School of Business, 1974.
2. American Society for Testing and Materials, "Standard Recommended Practice for Probability Sampling of Materials." [Designation E 105-58 (Reapproved 1970)], Section 2.
3. Morris H. Hansen, William N. Hurwitz, and William G. Madow, *Sample Survey Methods and Theory,* John Wiley and Sons, New York, 1953 (reprinted 1964), v. I, p. 9.
4. Committee on Auditing Procedure, AICPA, *Codification of Auditing Standards and Procedures* (SAS No. 1), 1973, Sec. 320A.05.
5. John Jacobs, "Statistical Sampling—Is It Being Utilized?" California CPA Quarterly, March 1971, pp. 9-10, 12, 14-16, 33.
6. Thomas M. Hubbard and Robert H. Strawser, "The Auditor and Statistical Sampling," *The CPA Journal,* August 1973, pp. 670-673.
7. 25 F. R. D. 351, 1960, pp. 426-7.
8. American Society for Testing and Materials: "Standard Recommended Practice for Choice of Sample Size to Estimate the Average Quality of a Lot or Process" (Designation E 122-72); "Standard Recommended Practice for Dealing with Outlying Observations" (Designation E 178-68); "Standard Recommended Practice for Probability Sampling of Materials" [Designation E 105-58 (Reapproved 1970)]; and "Standard Recommended Practice for Acceptance of Evidence Based on the Results of Probability Sampling (Designation E 141-69).
9. ASTM, "Choice of Sample Size . . .", *op. cit.,* Sec. 9.1.
10. ASTM, "Probability Sampling, . . ." *op. cit.,* Secs. 7.1.7, A1.2, A1.3.
11. *Ibid.,* Secs. A1.7, A1.8.
12. 369 F.2d 19 (10th Cir. 1966).
13. *Ibid.,* p. 27-28.
14. 324 F. Supp 1156 (D.N.H. 1971).
15. ASTM, "Choice of Sample Size . . ." *op. cit.,* Sec. 5.
16. 365 F. Supp. 707 (S.D.N.Y. 1973).
17. 350 F. 2d 580 (7th Cir. 1965).
18. *Ibid.,* p. 582-3.
19. *Ibid.,* p. 585.
20. 416 F. 2d 1236 (7th Cir. 1969).
21. 353 F. Supp. 69 (D. Conn. 1972).
22. *Ibid.,* p. 75.
23. 437 F.2d, 619 (2d. Cir. 1970).
24. 374 U.S. 321 (1963).
25. 240 F. Supp. 867 (S.D.N.Y. 1965).
26. Lozowick, Steiner, and Miller, "Law and Quantitative Multivariate Analysis: An Encounter," 66 Mich. L. Rev. 1641 (1968). Some other good, recent articles linking law and statistics are: Michael O. Finklestein, "The Application of Statistical Decision Theory to the Jury Discrimination Cases," Harvard L. Rev. 338 (1966); Leo Katz, "Presentation of a Confidence Interval Estimate As Evidence in a Legal Proceeding," *The American Statistician,* November 1975, pp. 138-142; and Joseph G. Van Matre and William N. Clark, "The Statistician as Expert Witness," *The American Statistician,* February 1976, pp. 2-5. (Our thanks to Robert Hamilton for calling our attention to these latter three sources.)
27. 110 F. Supp. 295 (D. Mass. 1953).
28. *Ibid.,* p. 305-6.
29. 259 F. 2d 69 (1st Cir. 1958).
30. 158 F. Supp. 50 (D. Mass. 1957).
31. Hawley Products . . . , *Supra* note 23 at 77.
32. 110 U.S.P.Q. 368 (1956).

33. 396 U.S. 320 (1970).

34. Comment, "The Civil Petitioner's Right to Representative Grand Juries and a Statistical Method of Showing Discrimination in Jury Selection Cases Generally," 20 U.C.L.A. L. Rev. 581 (1973).

35. Rev. Proc. 72-36, 1972-2 CB 771, 779.

36. *Ibid.*, p. 798.

37. House Miscellaneous Reports on Public Bills, Report No. 1643 1/4.6 74/7: V94; Report to accompany H.R. 10446.

38. R. Clay Sprowls, "The Admissibility of Sample Data into a Court of Law: A Case History." *UCLA Law Review*, February, 1957, pp. 222-232.

39. *Ibid.*, p. 230.

Discussant's Response to An Examination of the Status of Probability Sampling in the Courts

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It may be clear to some that the courts are increasingly dealing with issues of probability, or statistical, sampling and how it should be used. It may also be clear to some that auditors who continue to use judgment sampling in the performance of their audits should be prepared to defend their logic for doing so. However, the discussion by Professors Randall and Frishkoff will not support these conclusions. Further, as the authors indicate, it is certainly not clear how the courts will appraise the results of statistical sampling as part of the evidence used to reach audit conclusions.

On reviewing this paper, it occurs to me that there may be distinctions and observations that the authors have not made, which may assist in anticipating what attitude the courts may adopt in ruling on sampling questions that arise from audits of financial statements.

Considerations by the Courts

Only some of the cases cited turn on a court decision concerning the appropriateness of a sampling plan or particular statistical technique used. For example, in *Johnson vs. White*, the court reviewed the sampling plan and determined that it was appropriately devised and applied based on a review of the techniques employed. Two of the cited cases do not seem to deal directly with probability sampling. In *Commissioner vs. Indiana Broadcasting Corp.*, the issue seemed to turn on whether a Poisson distribution was either applicable or appropriately applied. This entailed consideration of whether proper judgments had been made in the planning stage, including whether the defined population had the appropriate attributes for the application of this statistical concept. Another cited case, *Super Foods,* appears to have been decided on a legal issue rather than on the issue of statistical techniques employed.

Putting aside these cases, I believe there is another characteristic implicit in the remaining cases that should be discussed. The paper notes that "references to sampling usually arose where the technique was being used to gather evidence rather than where it was used prior to the litigation, such as in an auditor's test of transactions." I believe it is significant that the cases cited typically seem to deal with specific attributes of a more or less well-defined population. However, the court's acceptance of probability sampling plans in these circumstances, in my opinion, does not indicate what its attitude would be in the much more complicated auditing environment. The expertise required of an auditor in devising

a sampling plan to help support general audit conclusions is sharply distinct from that required of an advocate developing evidence to sustain a particular position after the fact.

This leads to my next point. I am not surprised that there are no so-called "auditing cases" that deal with the issue of the appropriateness of statistical sampling applications or the lack of appropriateness of judgmental sampling. By its nature, the auditing process involves a series of judgments. The range of those judgments is so broad that there is little possibility that a case will turn on the very narrow issue of the specific sampling technique employed. One practical reason is that other broader areas, such as materiality of transactions and balances and the concept of reliance on internal control, are more promising areas for challenge in litigation involving audited financial statements. But those factors are outside the scope of this paper and it is sufficient to note that this is part of the backdrop for the current discussion.

Defensive Considerations

I believe that the genesis of this discussion paper was the suggestion that one of the advantages of using statistical, or probability, sampling is that "since the interpretation of the results is based on demonstrable statistical principles, the test is not only objective, but defensible, even before a court of law . . . or, even more important, before one's own conscience. Since the sample is objective and unbiased, it is not subject to the questions that might be raised relative to a judgment sample." As we have seen, Randall and Frishkoff have not been able to support this suggestion through their examination of actual legal cases. There is no evidence that statistical sampling would provide a better defense than judgment sampling when an audit undergoes the scrutiny of litigation. Let's look at the problem a little differently—why hasn't the auditing profession rushed to adopt probability sampling?

Reactions Within the Profession

At this symposium in 1972, Kenneth Stringer remarked on the increased use of statistical sampling, as follows:

> The reasons why progress [in the use of statistical sampling] has been more evolutionary than revolutionary are understandable, and have involved both statistical and auditing problems. The statistical problems have included the general unfamiliarity of auditors with statistical methods, and technical questions concerning the applicability of certain statistical methods to auditing situations. The auditing problems have related primarily to defining and expressing audit objectives in terms susceptible to statistical measurement, and to the difficulty of combining statistical and subjective evaluations of audit evidence in forming overall audit conclusions.

In my view, growth in the use of statistical sampling in independent audits continues at only a measured pace. This, in my opinion, is due less to the general unfamiliarity of auditors with statistical methods and more to the problem of relating statistical measurements to audit objectives and conclusions.

In his book on sampling in auditing and accounting, Herbert Arkin elaborates on the role of statistical sampling in audits, as follows:

> However, in considering the use of statistical sampling approaches by the auditor, it must be remembered that he is in a somewhat different position from that of the sampler in most other fields. He normally does not place total reliance on the results of a simple sample . . . in arriving at his decision, but he usually performs other examinations and a variety of other tests and analyses in evaluating the condition of the records and their impact on the accuracy of the financial statement.[1]

We may summarize the kinds of audit tests and their purposes, as follows:

- *Transaction reviews:* To confirm an auditor's understanding of the flow of data.
- *Functional tests:* To gather evidence that controls are functioning, thus permitting reliance on the underlying accounts.
- *Validation procedures:* To substantiate an account balance by confirmation, physical inspection, reperformance, or vouching.
- *Analytical reviews:* To corroborate a logical relationship among items or accounts.

At this point I should note that this framework is designed for purposes of discussion and conceptualization. In practice, these distinctions between audit procedures and their purposes are never mutually exclusive. For example, every transaction review contributes something to functional testing and often to validation and analysis as well. Moreover, the underlying logic is that, if transaction reviews and functional tests reveal no reason to doubt the reliability of the underlying evidence, an auditor is justified in minimizing validation procedures and analytical reviews. Conversely, if transaction reviews or functional tests reveal the possibility of doubt about the reliability of the underlying evidence, that doubt can often be removed or reduced sufficiently by validation testing and analytical reviews. Accordingly, the auditing process and the resulting auditor's opinion are based on a composite of not quite discrete testing components. Moreover, to the extent that we can identify such components, their contribution to audit conclusions and the auditor's opinion based on such conclusions are highly variable and characterized by the subjective and judgmental nature of the total audit process.

An Example

For example, in functional tests, examination of one item ordinarily demonstrates the existence of a control or controls, and, in most cases, examination of a few items demonstrates that the control or controls are functioning. Of course, the purpose of these tests is to determine whether there are disciplinary controls which reasonably assure the continued functioning of basic controls. In my opinion, the variety and nature of influences that affect the amount of evidence needed require the auditor to make a number of judgments in designing and applying sampling techniques, statistical or otherwise. Moreover, there is little agreement about what constitutes a sufficient test because several factors affect the degree of confidence an auditor may have in a specific system of controls, and he must take them all into account. Some of these factors are:

- The importance to the auditor of the data being controlled
- The type of control
- The effectiveness of disciplinary controls
- The type of conditions that lead to difficulty in maintaining control
- The auditor's overall assessment of the reliability of the accounting system.

Some Difficulties in Application

I am not satisfied that our "auditor's" understanding of the concept of sufficient control can be uniform enough to permit designation of measurements, such as those of confidence and precision, necessary for effective use of statistical techniques. Let me illustrate. My firm places stress on evaluating the components of controls. In our view, certain aspects of discipline, e.g., supervision, are more important to the auditor than other characteristics of control. Since there is no consensus yet in the profession on the usefulness of identifying the components of controls, I am certain we would fail to agree, for example, on what effect the lack of "adequate" supervision would have on the sampling plan. Even when the problems of sampling plans and sample size have been resolved, there is the issue of the judgment problems involved in evaluating sample results.

The authors' reference to their murky crystal ball includes a suggestion of a landmark case involving sampling in the auditing context. I haven't found a basis for the statement. But accepting it for the purpose of discussion, such a case will be decided on the court's appraisal of the auditor's judgments made in the assessment of the circumstances that support his conclusions as to the appropriate sampling plan to be employed. Whether probability sampling or judgment sampling is applied, the auditor and the courts must deal with the same critical decision. I believe that present probability sampling techniques do not offer special "protection or comfort" in this area for the auditor. In fact, I'm concerned that auditors may be misled by an "aura of acceptability" and be bitterly disappointed in the legal arena. Bear in mind that either method of sampling entails the same essential risk. For these reasons, I believe that the authors' cautionary statements are useful reminders and that a practitioner should weigh the likelihood that probability sampling will lead in practice to the same problems as judgment sampling in justifying his procedures.

Footnotes

1. Herbert Arkin, *Handbook of Sampling for Auditing and Accounting*, McGraw-Hill Book Company, Inc., 1963, p. 5.

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Use of Decision Theory in Auditing— A Practitioner's View

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Touche Ross & Co.

In 1974, Bill Felix delivered a paper at this symposium entitled "A Decision Theory View of Auditing," for which I was the discussant. At that time Howard Stettler asked if we would consider reversing roles in 1976. This paper is the result of our agreement to do so, with the caveat that I could speak only from the point of view of a practitioner since I am neither an academic nor a mathematician.

In planning this paper, I made a limited review of current academic literature on the use of decision theory in auditing and, in addition to Bill Felix' 1974 paper, found several notable works. These will be referred to below. I also formally surveyed a group of my peers to determine 1) their familiarity with decision theory and 2) their advice on how it might be used in auditing. Their response indicates that a very small proportion of practitioners have considered the subject formally. Without going into great detail, 70% stated they have no truthful idea of what decision theory is, 15% acknowledged having a general idea, and 15% stated they could specifically define decision theory as presented in the literature.

These findings should not be interpreted as evidence that auditors are ignorant or that they are making poor audit decisions, but rather that decision theory is a relatively new concept which has not yet been widely exposed to them. My feeling, as was expressed in 1974, is that if decision theory were presented to practicing auditors on a broader basis (e.g., in *The Journal of Accountancy*), the introduction would be successful only if the more technical aspects could be presented in the auditor's own terms. Since this introduction, to the best of my knowledge, has not yet been made, I consider the purpose of this paper to be input to that future undertaking. Accordingly, I have tried to identify a decision frame that I believe many auditors are using in a way that relates to formal decision theory, and to examine some of its implications.

Review of Decision Theory in Auditing

A broad definition of decision theory is an essential starting point. Decision theory is a systematized approach to problem solving such that the choices made will produce the optimum outcome. Formal decision theory utilizes statistical techniques extensively. Thus, relative to auditing, the use of statistical sampling,

particularly in the form of hypothesis testing, would be classified as part of decision theory.

As Felix and others[1] point out, however, the definition of the optimal decision should consider not only relative probabilities, but also the costs and benefits involved. These considerations are combined with the probabilities so as to lead the decision maker to take whichever available action will most likely provide the greatest payoff (or least cost). Kinney presents the following general model:

$$E(W|a^*) = \min \Sigma W(s,a)P(s)$$

Where E(W) is the cost expected to arise from action a*, the optimum action (i.e., the one producing the lowest cost) from all possible actions a with cost W associated with states s given the probability P(s) that each state s exists.

As illustrated by Felix, this can be related in auditing to two states and respective actions (Figure 1):

FIGURE 1

Basic Audit Decision

Actions	States s_1—Material Error Exists	s_2—No Material Error Exists
a_1—Render Unqualified Opinion	20	−7
a_2—Require Adjustment or Qualify Opinion	−3	1

In this illustration, the matrix contains the net cost W (positive) or benefit −W (negative) associated with each possible a/s combination. If $P(s_1) = .1$ and $P(s_2) = .9$, we have the following:

$$E(W|a_1) = .1(20) + .9(-7) = -4.3$$
$$E(W|a_2) = .1(-3) + .9(1) = +.6$$

Thus, a_1 is optimum in this case as it produces a negative cost (benefit), and the auditor would choose to render an unqualified opinion.

Felix and Kinney have both examined a logical extension of the model at this point—the problem of deciding whether to examine additional audit evidence before the decision is considered final. Kinney further processed hypothetical assumptions through the model to determine its sensitivity to the various factors involved.

Dacey[2] has studied a problem that I raised in my 1974 discussion—that of the model leading to a premature decision. Dacey recommends that auditors consider a model based on conclusion theory, which provides for acceptance of all hypotheses which meet certain criteria, not just one "optimal" hypothesis. The possibilities are held open until adequate conclusive evidence about a single hypothesis is obtained.

Scott[3] has also examined these problems and has attempted, as have Demski and Sweringa,[4] to relate this internal model to outside models. In the case of Scott, to the capital market, and in the case of Demski and Sweringa, to a joint problem of the auditor and management.

For my purposes, however, I shall consider two key aspects in the basic

model in Figure I: the cost of making the wrong decision and the probability that a material error exists. I shall then consider the implications of these aspects on the decisions commonly made by practicing auditors.

Cost of Making the Wrong Decision

Figure 1 indicates two possible wrong decisions: the issuance of an unqualified opinion when a material error exists (a_1, s_1), which I will henceforth call a *Type I* error[5]; and requiring an adjustment or qualifying when no material error exists (a_2, s_2), which I will call a *Type II* error.

When a Type I error is made, the results can be disastrous. The auditor can be held liable for damages suffered by the client on the basis of a tort action for negligence, or the auditor can be held liable to third parties on the basis of gross negligence, or be held liable for violation of the securities law in certain instances. Of particuar concern, is the further possibility of criminal charges under both federal and state laws. This occurred in circumstances in which most auditors would hardly believe that a *crime* had been committed, in both the Continental Vending and National Student Marketing cases.

To illustrate the possible magnitude of direct loss, suppose the auditor were required to pay damages to a third party for gross negligence and incurred legal fees for a grand total of $5,000,000. (Amounts of this general magnitude have been incurred in several instances.) Also suppose the audit fee for the engagement was $500,000 per year. Based on my experiences with the operations of an international CPA firm, I estimate it would take over forty years of net income from audit fees to recover this loss.

The indirect costs of a Type I error are not as easy to measure, but they are of great concern. A tremendous amount of energy is sapped from the firm by a serious lawsuit. Attention of a number of high level partners is required, and the attention of others is diverted. Not only is there a loss of these persons' time, there is a loss of the leverage they command as well. There is also the possibility that a special peer review would be required which would cost several hundred thousand dollars and require considerable time. A negative environment can be created. Additionally, the firm's reputation can be damaged to the point where potential opportunities and even existing clients can be lost. One serious Type I error can overshadow good work done on ten thousand other clients. It can ruin careers and even lives.

Type II errors are individually less costly, but at a relatively uncritical level, more likely to be incurred. There is a great deal of pressure in auditing to control hours worked. This results from client fee concerns and engagement scheduling problems caused by turnover and work peaks. Often, where apparent errors are uncovered, the auditor will approach the client to request an adjustment. The client may react by refusing, and additional work will be done to resolve the situation. Where the matter is resolved in favor of the client, a Type II error has been made and corrected. The client may or may not agree to pay the auditor for this additional work. If this strategy is followed extensively, the auditor may irritate the client to the point where the auditor is replaced.

If the client accepts the auditor's request for an adjustment or if a qualified opinion is issued when a material error does not exist, the Type II error reaches

the critical stage of impacting the published financial statements. Although low chance of discovery is a factor, it is possible the client could suffer damages, and a lawsuit against the auditor could result.

Another aspect of the Type II error problem is the possibility that an auditor may seek additional protection by extending the amount of work performed. If the engagement is for a fixed fee, there is a cost to the auditor for any unnecessary work that is performed. If per diem rates are charged, the client bears the cost, but if the auditor's fees become excessive, the loss of clients becomes a possibility, with the attendant cost to the auditor.

In contrasting the relative magnitudes of the two types of errors, as a practitioner I would certainly want to control both of them, but in the final analysis, Type I far overshadows Type II. The lawsuits resulting from Type I errors have dominated our environment for several years now; they are a study in and of themselves. Although we carry large amounts of insurance to cover losses that can occur, such insurance is only a long-term financing mechanism. Any large loss will be rebilled to us in future years with interest.

For these reasons, I believe that when auditors make the decision to issue a report, the losses associated with Type I errors are foremost in their minds. They first decide: "Is there any real chance the opinion should be qualified?" If the answer is affirmative, they will go to great lengths to be satisfied. If the answer is negative, it is unlikely that much additional work will be performed beyond the minimum level associated primarily with tradition or internal policy.

This approach is at least partially consistent with the formal decision theory model. The differences are:

1. The decision to extend work is biased toward a one-sided expected cost consideration—i.e, the cost of a Type I error.
2. A third decision point can be reached where the auditor cannot substantiate the basis for a qualification, yet is afraid to give an unqualified opinion because of the circumstances. Here the alternatives may be to disclaim an opinion or withdraw from the engagement.

This second aspect is explored in more detail in the next section.

Probabilities Associated with Type I Error

Given that the decision framework just described is legitimate in the current auditing environment, a logical audit strategy would be to:

1. Allocate audit resources as efficiently as possible to minimize the risk of giving an erroneous unqualified opinion.
2. Establish a standard for an acceptable level of such risk beyond which an unqualified opinion would not be rendered regardless of the inferences that may exist (i.e., unless a qualification is clear, disclaim an opinion or do more work).

Generally accepted auditing standards aim at these objectives, but they are far from specific. With regard to the first, there are definitions about general types of audit tests and procedures (i.e., compliance, substantive, analytical, confirmations, etc.), but little indication as to mix or preference.

With regard to the second objective, the minimums set by generally accepted auditing standards should provide at least a qualitative floor for acceptable risk. Certainly the discussions about competent evidential matter, independence, due care, and statistical sampling, for example, give some idea of what is expected. However, these become largely abstractions when a single examination is involved; and the abstraction is made more severe by the absence of clear-cut guidelines for determining materiality.

Thus, the auditor is in a position where the audit risk cannot really be measured, and the notion of the risk being taken must be compared to a presently undefinable standard. Is this bad? No, it is simply the way it is, and as time goes on clearer standards should evolve. In the meantime, how can the auditor minimize risk?

As indicated in SAS 1,[6] the risk of making a Type I error can be viewed as comprising two separate risks: Ia—the risk that a material error is committed and exists in the financial statements, and Ib—the risk that the auditor fails to discover that fact. A complexity to this formulation is that when the Ia risk is great, *it may also be that Ib is great due to the circumstances that relate to Ia.* For example, if the Ia risk is great because of an inadequate record keeping system, Ib may be great because the system does not provide audit evidence to inspect. It is important to recognize this interaction because it implies that in certain circumstances where Ia is great and the interaction exists, it is not possible to perform an audit in accordance with professional standards. In such situations, the auditor should recognize this at the outset and withdraw from the engagement, rather than attempt an audit for which the fee may not be collected, incur extreme client/user dissatisfaction, and/or be faced with a high risk of Type I or Type II errors.

The specific magnitude of Ia risk cannot, of course, be measured objectively. However, conditions which will indicate its general magnitude can be appraised. Thus, where Ia is low or moderate, certain strategy alternatives relative to controlling Ib can be available; whereas, if Ia is high, disengagement or a special set of procedures should be considered.

Figure 2 presents the factors which affect the propensity for a material error to exist, the possibility of interaction with Ib risk, and the steps available to the auditor to make an appraisal of the risk and/or to achieve some control over it.

Thus, we see that there are very strong interactions between the integrity of management and the design of internal control, and the auditor's ability to gather sufficient competent evidence. If management is dishonest, it may conceal evidence or make false representations to the auditor, which cannot be overcome with evidence-gathering procedures. The common thread in many of the notorious lawsuits against CPAs is the presence of dishonest managements. Finally, if the design of the system of internal control is such that economic events can occur and yet escape capture by the system, adequate evidence may not be available for the auditor to examine.

A possible interaction exists where the industry is unique and an industry expert is not available; perhaps the audit should not be undertaken. In cases where the company is having problems with excessive growth or possible insolvency, or if client personnel lack competence, errors may be more likely, but the auditor's ability to find them may not be affected. On the other hand, where

FIGURE 2

Factors Related to Existence and Detection of Material Error

Factors Which Increase Propensity for Material Error	Interaction with Risk of Nondiscovery	Steps Available to Auditor (or Audit Firm) to Appraise or Control Risk of Material Error
• Nature of industry	Possible	• Use of industry experts • Control of industry mix
• Nature (condition) of business	Possible	• Financial analysis • Client profiling techniques
• Integrity of management	Strong	• Client investigation procedures (new and repeat) • Score card (retrospect) of client representations
• System of internal control—i.e., design	Strong	• Table of transactions and sources of evidence • Preliminary evaluation
• Competence of client personnel	Possible	• Observation • Tests of data

the condition of the business causes management to compromise its integrity, or where incompetent personnel make auditing such a painful and time-consuming process that the auditor takes unwarranted expediences, interaction occurs.

Some of the steps listed opposite each factor are familiar ones. Others may be new. Following are comments on the relatively unusual steps:

Financial Analysis. This is not new in itself, but more advanced models are beginning to be used by auditors. Specifically, bankruptcy prediction techniques are being used for the purpose cited here. Two techniques used by Touche Ross are a discriminant analysis by Altman[7] and a gambler's ruin model developed by Wilcox.[8]

Client Profiling Techniques. Some audit firms recognize that certain client characteristics are related to greater risks, and a profile is maintained citing these characteristics for audit clients. This is kept current and reviewed at least annually to consider whether the audit program adequately considers the risks involved.

Score Card of Representations. Throughout an audit, certain representations are requested and made by responsible client personnel. For example, the collectibility of specific accounts receivable and the ultimate outcome of construction projects in process. A record of these by person is maintained in the permanent file, and in subsequent periods the actual results are entered to judge the accuracy of the representations.

Table of Transactions and Sources of Evidence. This technique requires the auditor to identify all possible economic events which are likely to occur with regard to the entity. These are generally described as types of transactions and are constructed into one axis of a two-dimensional matrix. The other axis lists all sources of evidence available to the auditor about those events. These are generally divided into specific internal control subsystems of the entity and other sources, such as outside confirmation, board of directors' minutes and direct

physical observation. The body of the matrix indicates the relationships between the axes and allows the auditor to make preliminary appraisals and plans. Specifically, it is possible to see whether there are any transactions which lack substantive evidence sources, to determine which systems must be evaluated and the extent of potential reliance on internal control, and to plan the proper sequence of audit steps.

Figure 3 presents in a fashion similar to Figure 2 the factors which affect the auditor's risk of failing to discover material errors should they exist.

FIGURE 3

Factors in Failure to Discover Material Errors

Factors which Affect the Auditor's Risk of Non-Discovery of Errors	Steps Available to the Auditor (or Audit Firm) to Control Risk
• Scope and terms of engagement	• Engagement letter
	• Audit plan
• Reliability of audit evidence	• Selection of evidence—direct vs. indirect
a. Nature (effectiveness)	
b. Timing	
c. Extent	
• Performance by auditor	• Training
	• Instructions
a. Capabilities	• Staffing
	• Tools
b. Conditions	• Review

The factors shown relate to the auditor's achieving the position where there is clear agreement about the examination to be performed and the feasibility of such performance, and where there is certainty that the audit conclusions are sound. This latter aspect relates to the evidence itself and the proper interpretation of the evidence. Interpretation is used in the broad sense of not only evaluating what is observed, but observing what is available. Interpretation is behavioral. Proper interpretation requires knowledge, experience, alertness, and similar personal strengths in the individual auditors involved. However, the conditions under which interpretation is accomplished are also a factor. The physical form of the documentation of the evidence gathered influences interpretation; also, any time constraint under which the interpretation must be made has an effect. It is interesting to speculate how the need to meet tight deadlines for a registration statement or an early annual report issuance during the "busy season" affects the auditor's judgment in this area.

Selection and Evaluation of Evidence

With regard to the steps available to deal with the factors, the most pertinent set deal with the selection of evidence. The theory of evidence can be presented in various ways; I have chosen here to distinguish between *direct* and *indirect*

forms of evidence. (I do not intend, however, to present a comprehensive theory of evidence.)

Direct evidence is defined as evidence of the monetary amounts recorded in the financial statements, as of the financial statement date. Indirect evidence is defined as all other evidence. One might argue that an ideal audit would contain all direct evidence, i.e., risk would be minimized. On closer inspection, however, this may not be true, because the relative *quality* of the available indirect evidence may be better than that of the available direct evidence, and obtaining indirect evidence might enhance improved performance by the auditor.

First, let's consider the quality of the evidence. The quality of a single type of evidence relates to the source of the evidence and effectiveness of the audit procedure used to obtain it. For example, with an account receivable confirmation, the source of the evidence is an outside party—a high quality source. The effectiveness of the audit procedure, however, will vary depending on the reliability of address information, the design of the request, the nature of the industry, and the characteristics of the customer. On the other hand, a management representation may not constitute adequate evidence because of its source, even though the auditor's interviewing techniques are effective.

Where the quality of a single type of evidence is lacking, the auditor must generally obtain evidence of other types. If all indicate the same conclusions, their aggregate quality will be significantly enhanced. This is a point that should be noted because traditionally some auditors have confused evidence *quality* with evidence *quantity*. As a result of this confusion, they have attempted to compensate for a relatively ineffective audit procedure by taking large samples. It should be quite clear that the bias introduced by improper measurement of sample values has a severe effect on the sampling distribution regardless of the sample size.[9] Thus, the auditor may be better off taking relatively small samples of more types of evidence whenever the quality of a single type is not clearly superior.

Many of the types of indirect evidence relate to testing the internal controls of the client organizations and balances at interim dates. Both of these approaches allow a large amount of audit work to be spread throughout the fiscal year preceding the financial statement date. This enhances planning and control and effective staffing—conditions which can reduce audit risk. Internal control testing also has the advantage of providing evidence of a second type relative to other direct evidence.

The danger of these approaches is concerned with the difficulty of relating the conclusions to the financial statement balances. Where reliance is placed on internal controls, an appraisal must be made relating the effectiveness of the various subsystems to potential monetary errors in the accounts. This is a complex task and it is questionable whether it can really be done subjectively except in vague terms.[10] The problem with interim-date tests relates to the risk that conditions may change between the interim date and year end. The appraisal of this risk is closely related to the evaluation of internal control.

Non-Sampling Error

Non-sampling error—the result of incorrect performance by the auditor—causes bias in the same manner as an ineffective audit procedure. Non-sampling

error can result from assigning the wrong person to a specific audit task, or from subjecting the auditor to conditions where fatigue, boredom, or other personal weaknesses might occur. These can be controlled by a variety of approaches as shown in Figure 3.

It would appear that the aspect which most closely relates to the formal decision theory model is the determination of the extent of procedures—i.e., sample size. Both the costs of sampling and probabilities can be specified for a decision model in much the same way as with classical sampling. The difficulty would occur in attempting to specify the cost of a Type I error (as I have defined it) because this relates to the aggregation of *all* evidence, not just the results of a single test. The jump from individual tests to the overall aggregation appears to be the greatest challenge to formal model usage.

Summary

The concepts of formal decision theory are extremely useful to auditors as a means of recognizing which elements of audit effort should receive available audit resources. Traditionally, there have been observations that too much time is spent on trivial areas or areas which are "the easiest to audit." I have attempted to present the audit framework in such a way that various elements can be discussed relative to their effect on the risk of issuing an unqualified opinion when material error exists in the financial statements, as I believe this risk is of pervasive concern among practicing auditors.

In controlling this risk, it was indicated that the auditor should appraise the client's propensity to commit a material error. Most significantly, two factors—integrity of management and design of internal control—have strong interactions with the auditor's ability to discover errors. If these factors are negative, disengagement or disclaimer is advised. It is also possible that other factors—nature of the industry, condition of the business, and competence of client personnel—could have similar interactions in some circumstances.

Based on the importance of this aspect of risk, one would expect auditing firms to establish standards and procedures for the initial and continued acceptance of clientele, the use of financial analysis on all audits, and the development and use of industry experts. One interesting social consequence of all auditing firms adopting such policies would be to set minimum standards for managements to qualify for audits.

In examining the various aspects relating to the auditor's discovery of errors, it was indicated that the effectiveness of procedures and control of non-sampling error were essential prerequisites to further assumptions relating to sample size. Although these factors are most often discussed in the context of statistical sampling, they apply to judgmental samples as well.

The key point to be made regarding the risk of non-discovery, however, is that the proper combination of all elements is not clear, and would not be universal for all audits. The phrase "appropriate in the circumstances" has real meaning here. The auditor's skill provides as meaningful and effective a basic recipe as can be contrived, and further assistance should be available through firm and professional standards, guidelines, and tools. In this regard, auditing firms can be expected to deal with such issues as:

- What training costs will be incurred.
- What minimum duties and responsibilities should be defined for partners, managers, and staff.
- When specialists must be consulted.
- When certain tools, such as questionnaires or statistical sampling, must be used.
- What audit procedures must always be done at year-end.
- What constitutes minimum reliance on internal controls.
- What types of workpaper review are necessary.
- How technical issues are resolved.

Some of these issues have passed to the professional level. A review of pronouncements indicates a predominant concern with control of Type I errors. SAS 4, Quality Control Considerations for a Firm of Independent CPAs, for example, cites areas where firms should have policies established and gives examples. And the current Auditing Standards Executive Committee agenda includes additional such items, such as management's illegal acts and the auditor's responsibility for detection of fraud. Little that has happened in the profession of late has resulted in less auditing.

All of this leads up to the point of the next logical question—"what is the relationship of the costs and benefits of auditing?" Are the benefits sufficient to justify those costs?[11] Can the cost factors be changed, e.g., through legislation of legal liability statutes? Until such issues are made more clear, it will be difficult to gain agreement on what constitutes *reasonable assurance* in auditing. And until reasonable assurance and materiality are more clearly defined, auditors will continue to take their present defensive position of acting to minimize the Type I risk.

One of the issues of the Commission on Auditor's Responsibilities[12] is the cost-benefit issue. Successful efforts by the commission will facilitate more formal use of decision theory in auditing.

Footnotes

1. Throughout this section I have drawn on three excellent sources for material on decision theory in auditing:
   —Dyckman. T. R., "Some Contributions of Decision Theory to Accounting," *Journal of Contemporary Business,* Autumn 1975.
   —Felix, W., "A Decision Theory View of Auditing," *Contemporary Auditing Problems,* ed., H. Stettler, University of Kansas School of Business, 1974.
   —Kinney, W. R., Jr., "A Decision-Theory Approach to the Sampling Problem in Auditing," *Journal of Accounting Research,* Spring 1975.
2. Dacey, R., "A Conclusion-Theoretic Resolution of the Auditor's Detection Problem," Working Paper No. 75:13, University of Oklahoma Center for Economic & Management Research.
3. Scott, W., "A Bayesian Approach to Asset Valuation and Audit Size," *Journal of Accounting Research,* Autumn 1973.
4. Demski, J. and Sweringa, R., "A Cooperative Formulation of the Audit Choice Problem," *The Accounting Review,* July 1974.
5. I realize that under conventional hypothesis testing, this may be labelled as a "Type II error." To the auditor, however, it is the error of greatest concern, and the definition "Type I" would seem more consistent with his view. This has been my experience in teaching statistical sampling to auditors. Where the hypothesis test has been framed so that the "alpha risk" represents the risk of accepting a materially misstated account balance, it has enhanced understanding.
6. Statement on Auditing Standards No. 1, Sec. 320A.14.

7. *See* Altman, E. I. and McGough, T. P., "Evaluation of a Company as a Going Concern," *Journal of Accountancy,* December 1974; and Altman, E. I., "Corporate Bankruptcy Prediction and Its Implication for Commercial Loan Evaluation." *The Journal of Commercial Bank Lending,* December 1970.

8. *See* Wilcox, J. W., "A Gambler's Ruin Prediction of Business Failure Using Accounting Data," *Sloan Management Review,* Spring 1971.

9. *See* Loebbecke, J. K. and Neter, J., "Considerations in Choosing Statistical Sampling Procedures in Auditing," *Proceedings of Conference on Statistical Methodology in Auditing,* University of Chicago, May 1975 (to be published in Journal of Accounting Research Supplement).

10. *See* Burns, D. C. and Loebbecke, J. K., "Internal Control Evaluation: How the Computer Can Help," *Journal of Accountancy,* August 1975.

11. As but one example, this is particularly pertinent to the current issue of auditor involvement with interim financial statements in deciding whether 1) all reviews should be voluntary (initial AICPA position), 2) reviews should be mandatory (SEC position re publicly held companies), and 3) public reporting should be allowed on the basis of a review vs. a regular examination.

12. Statement of Issues: Scope and Organization of the Study of Auditors' Responsibilities, AICPA, Para. G-1, D.

Discussant's Response to Use of Decision Theory in Auditing—A Practitioner's View

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Jim Loebbecke is to be complimented on his willingness to provide a practitioner's view of a topic area that is, I am sure, very difficult to deal with.

Researchers interested in using decision theory as a descriptive model of auditing practice need feedback and criticism from practitioners. Otherwise, it is very likely that inaccurate models and inferences from these models will result. I would particularly like to observe the importance of contributions such as the auditor's logic process that Jim provided in his 1974 comment on my paper. These views of the basic audit process, including (1) steps for the collection of particular kinds of evidence and (2) steps that represent major decision points in the audit process, are the kind of basic information and feedback that is necessary to construct useful models.

Significance of Research on Decision Theory

The significance of the research efforts in decision theory may not be entirely clear. The line of argument that is most appealing to me is that a decision theory model requires rather precise specification of relationships and decisions that may have previously been left rather vague and imprecise. The result of greater precision ought to be better understanding of the consistencies and differences in the various opinion formulation processes being used in the profession. In addition, the resulting well structured and understood models would improve the ability of researchers to investigate problems and by implication, for the profession to adapt to changes.

Possible Misconceptions

On the first page of his paper, Jim indicates that approximately 30% of the practitioners he surveyed have some idea as to what decision theory implies with regard to auditing. Being realistic, I suspect that this is a fairly optimistic figure. There are probably only a handful of practitioners in this country that can approach Jim's knowledge of this particular application of statistical inference. Yet I think that his paper indicates that he has some misconceptions about the nature of decision theory, either as a normative model of the auditor's decision processes or as a descriptive model of how auditors behave. Let me illustrate my point with a couple of observations from Jim's paper. In the last paragraph on page 110 of his paper under "point 1" he states that the decision to extend work is

biased towards a one-sided expected cost. That is, that the auditor is so overwhelmed by the potential impact of Jim's Type I error that other potential decision factors don't matter. I would agree that this outcome is possible, but it seems to me that regardless of whether or not this situation will exist, a decision theory model will handle it properly. The auditor's degree of belief or probability for this type of error is used to weight the cost of the error so that the result or expected value is used in making choices. Regardless of how overwhelming the consequences of such an error, if it is of very low probability or very unlikely to occur, it may not be significant in the final outcome. Some of Jim's discussion indicates that he understands this point yet he is describing it here as a difference in the model.

Risk Assessment

On page 111, Jim's discussion indicates some concern about the objectiveness of the assessment of the risks the auditor uses in decision making. It is my belief that the critical assessments of risk made by the auditor are now, and always will be subjective. Decision theory, or its use in auditing, does not imply an objective measurement of risk. All that is required is that in some way the auditor elicit subjective assessments of risk and combine them with whatever objective sampling evidence is available to reach a composite risk assessment that is then used for decision making. This point is raised again on page 115, where Jim states that it would appear that ". . . the aspect (of auditing) which most closely relates to the formal decision theory model is the determination of the extent of procedures—that is, sample size." It may be that most near-term applications of a decision theory model would be in audit decisions that relate to samples and sample sizes, but the use of the model itself is primarily oriented toward the combination of the results of judgment and sampling in order to reach audit decisions both in terms of individual tests and as the auditor aggregates evidence from a variety of sources to reach overall decisions on balances and the financial statements taken as a whole.

Audit Process Model

To illustrate, let me refer to the flow chart in Appendix I. As complex as this chart appears, it is only a partial model of the audit process. It presents the elicitation, assessment, and evidence composition problem for accounting systems, the conversion or transition from accounting system error rates to account balance error rates, the assessment of balance error amounts and their composition for total error amounts, and the individual account error amount aggregation problem, all in one chart. Clearly missing are the beginnings of the process where the auditor engages in a general learning process before trying to disaggregate this general evidence to priors on the error rate for specific procedures, the contribution of this general learning to assessments for decision problems throughout the audit process, and most critically, the specification of the terminal loss function which will be used for decisions throughout the process. The major point that I would like to make from the chart is that it indicates that a decision theory model is certainly not oriented primarily toward determination of the extent of audit procedures. It is far broader.

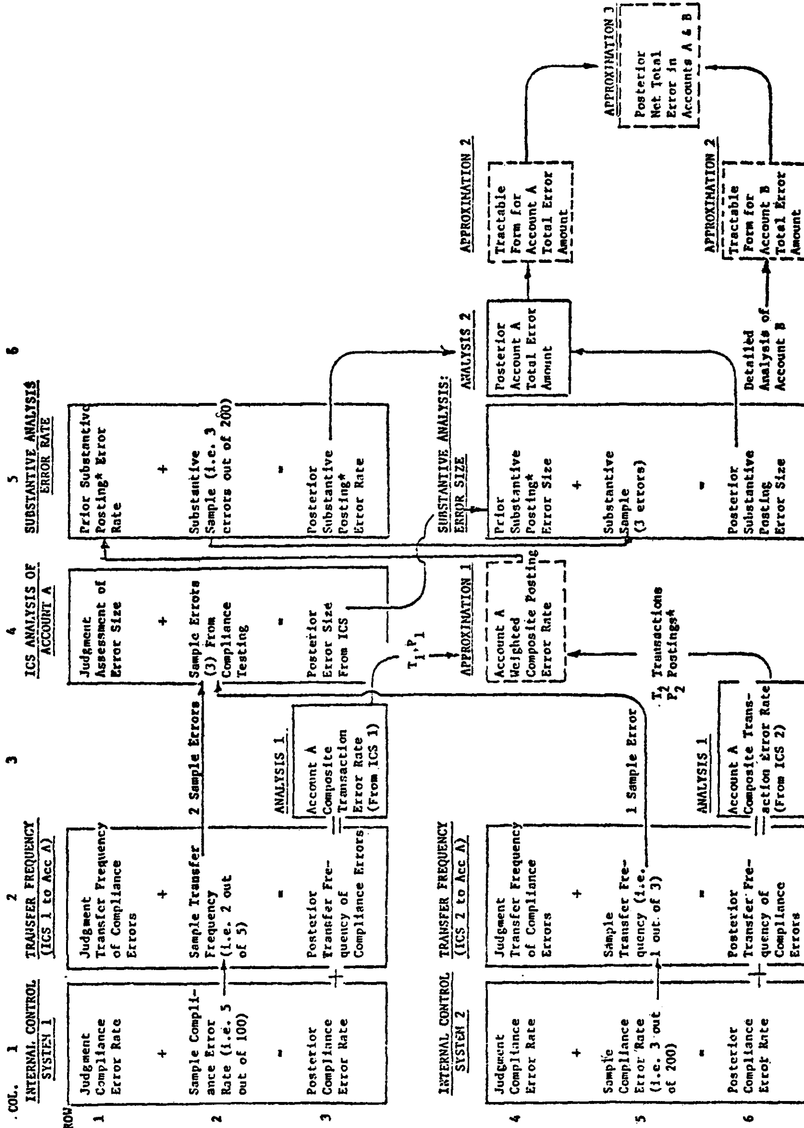
On page 110, Jim observes that the two-state decision model in my prior paper does not represent all the alternatives. I would certainly agree that the model was designed primarily to illustrate the potential rather than to be a definitive description. In another paper, a student and I have addressed the problem of expressing the auditor's payoff function more realistically. Appendix II illustrates a possible specification of the auditor's action space. Note that the action space includes a clean opinion, various kinds of non-standard opinions, and withdrawal from the engagement.

Appendix III illustrates the nature of the loss functions that we are exploring. These models allow inclusion of both fixed and variable losses. Each functional form is made up of, at most, three plateaus, corresponding to immaterial near zero error amounts, small error amounts, and extremely large error amounts. The change from one plateau to the next starts out slowly, builds up rapidly, and then slowly approaches the target plateau. Also, rather than argue for a single payoff function, we suggest a decomposition of the assessment problem into three components: professional reputation, legal costs, and settlement costs.

In conclusion, I would like to return to the title of Jim's paper. We are not ready for the *use* of decision theory in auditing, and many of Jim's comments are indicative of the reasons why such use is not now being proposed. Continued research and teaching of decision theory in auditing are both desirable, however, because of the potential of this methodology to make us better heuristic decision makers, and the promise of the research to achieve those benefits in understanding and communication mentioned at the beginning of my comments.

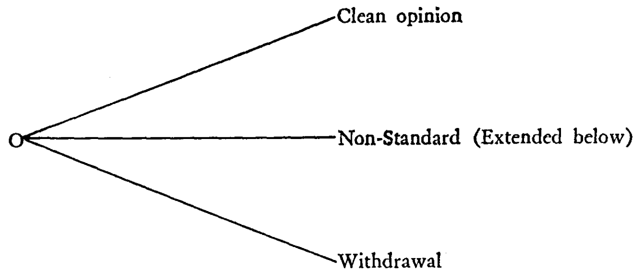
Appendix I

Logical Structure of the Evidential Integration Framework



Appendix II

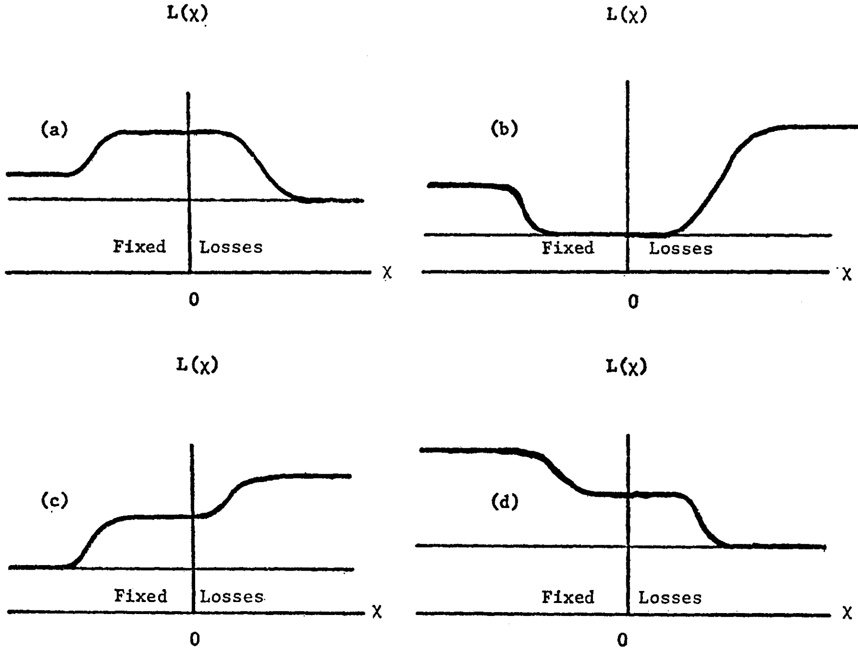
Specification of Auditor's Action Space



A Classification of Nonstandard Opinions

	Level of Materiality	
Cause	Moderate	Severe
1. Scope restriction	"Except for" opinion qualification	Disclaimer
2. Unusual uncertainty	"Subject to" opinion qualification	Disclaimer
3. Client-auditor dispute on GAAP	"Except for" opinion qualification	Adverse opinion
4. An inconsistency in principle or entity	"Except for" consistency qualification	ϕ

Appendix III
Three Plateau Loss Functions



L(χ) = The present value of after tax losses corresponding to error amount χ.

χ = The aggregate error amount.

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Capital Investment and U.S. Accounting and Tax Policies

Richard D. Fitzgerald
Price Waterhouse & Co.

Capital formation is the lifeblood of our industrial and economic complex. Yet we hear increasing warnings of the problems ahead from undercapitalization of American business and the resulting constraints on production and employment.

Historical Background

For years, American business has been largely self-financing. Fifteen years ago, close to 90 per cent of corporate capital expenditure was supplied from internal cash flow—retained earnings and depreciation. This proportion has dropped significantly, although recently improved corporate earnings should help for the short term. We are all aware of the collapse in equity market financings in recent years. From a high point in 1972 of nearly $15 billion in equity offerings, there has been a dramatic decline in the last two years. The difficulty of raising equity capital on a reasonable basis has been accompanied by record levels of corporate indebtedness—an amount outstanding nearly as large as one year's GNP. Debt to equity ratios have risen sharply in the last decade. Of particular concern has been the marked increase in short-term indebtedness which requires continual refinancing.

One U.S. businessman has summarized his view of the basic capital problem:

> The shortage of equity capital has been especially worrisome. This has forced us to rely on short-term and long-term debt to finance innovation, modernization and expansion. Consequently, interest cost has become a significant added expense, depressing profits. Lower profits make it more difficult to generate retained earnings. Lower earnings and a high debt to equity ratio further depress the value of the company's shares, making equity financing even more difficult.

While a number of studies have been made of the potential capital shortage, there are, as you might expect, as many different answers as there are studies. The New York Stock Exchange, in its often-quoted study of capital needs, has estimated a frightening shortage of savings compared to capital needs—$650 billion over the next ten years. Their study was based on projections of desired levels of investment and available savings under basic assumptions of 3.5 percent real growth and 5 percent inflation annually. Several other studies, such as Chase and Business Roundtable, also reflect shortages. The Brookings study,

based on lower levels of inflation and unemployment and larger government surpluses, shows about a breakeven over the period to 1980. It may be that these studies and the many comments provided in hearings have not yet fully convinced Congress, but the outpouring has certainly made a sizable impact on its members judging by the variety of proposals being seriously considered by Congressional task forces.

Quantifying the Problem

Whether or not it is possible to conclude on some quantification of capital needs for the next decade, there seems to be growing recognition that the social objectives pursued by government have created bias in the direction of consumption rather than savings and that it is time to assess and moderate the discentives affecting capital investment. We know that one and one-half million new workers will be moving into the job market over the next ten years at a minimum investment cost of $35,000 each. This will account for at least $50 billion a year of new investment. There also will be the replacement, modernization and environmental demands of the future—all to be considered in light of continuing inflation. If there is no staggering shortage of the magnitude shown by the NYSE study, it does seem reasonable to conclude there will be no surplus either.

Senators Javits and Humphrey, not particularly noted for their conservative banners, in jointly sponsoring certain legislation for employee stock ownership plans, have commented within the last month on their concerns with capital formation:

> (I)t is no secret that the United States is experiencing a substantial problem with respect to a shortage of capital investment. The U.S. Treasury estimates that from 1960 to 1973, investment as a percentage of real national output was 13.6 percent in the U.S. as compared to 29 percent in Japan, 20 percent for West Germany and 18.2 percent for France. What is needed to alleviate the capital shortage of the 1970's and 1980's are new approaches to equity investment. (Javits)
>
> In recent years new stock issues have only contributed 2 to 5 percent to corporate financing needs. Last year, for example, just 568 companies used new stock issues to help raise capital. I believe that is an unhealthy situation for the U.S. economy and one that must begin to have some remedies applied if we are to meet the large capital needs of the coming decade. (Humphrey)

Cause and Effect

The effects from inability to raise the desired capital are not difficult to foresee. In a capital intensive country, the initial consequence will be evidenced by continuing unacceptable levels of unemployment. The reduction of investment must necessarily mean curtailment of plant expansion, modernization and research and development. There is no way that technological improvement can be sustained and new job opportunities created without the required investment input. There is no way productivity can be enhanced if industry cannot buy the equipment necessary to do the job. Moreover, the scramble by industry in capital scarce times produces the high interest rates that help close the cycle for stifling

earnings and impeding economic growth—as we have been so painfully aware in the last two years.

World Interdependence

In assessing U.S. needs and objectives, clearly economic interdependence around the world is a reality. While the severity of cyclical swings may vary from country to country, there is direct linking of investment resources and demand. Inflation, currency exchange rates, and interest rates all involve worldwide consideration. Not too long ago in the U.S., we were pre-eminent with our abundant raw materials, cheap energy, super technology, high volume, and profitability. It doesn't take much reflection to recognize that those days may be gone forever. We are now faced with either scarcity in some resources or control over their supply held by other nations. The technology achievements and productive capability of some countries provide the keenest, if not superior, competition to our own industry. In fact, the emerging economic and political order in the world demands a larger sharing in production and revenues by less industrialized nations.

In preserving and building its capital base, business must continue to sharpen its own management technique to optimize return from new expenditure, to conserve its liquid resources and to take full advantage of tax and other opportunities to retain capital. For many companies, the LIFO inventory method has helped alleviate capital erosion. Despite the pain of reducing reported earnings, hundreds of companies made this move in the last few years to preserve capital that would otherwise have been paid out in income taxes. Although it seems business managers are carrying the struggle as well as possible, the resolution of capital shortage problems ultimately has to rest with motivation and government policy.

Taxation Policies

Of prime importance in stimulating capital investment is the taxation system. Our federal tax system is built substantially on the income tax—a tax inherently unfavorable to investment. In fiscal 1975 about 60 percent of federal revenue came from personal and corporate income taxes. As government has grown and tax rates increased, what the reformers choose to call "loopholes" are whittled here and there into the structure to permit some money to flow into investment. This kind of tax system means permanent conflict between government's revenue appetite and the nation's capital needs.

In effect, the U.S. has maintained a tilt in tax policies toward consumption and away from savings and capital formation. Our tax experts point out a number of shortcomings when the U.S. tax system is compared with other industrialized countries.

Capital cost recovery on fixed investment. The adoption of the ADR class life system in 1971, together with the restored investment credit, did improve capital cost recovery in the U.S. It is estimated that with regard to fixed investment since then, using double-declining balance, about 60 percent of the original cost can be allowed for tax depreciation in the first three years. Nevertheless, compared to other countries, the U.S. is still nearly at the foot of the class. For

example, the U.K. allows 100 percent recovery in one year; Canada in two years; Sweden in three years.

Inflation adjustments. The U.S. has no provision in tax law for inflation recognition unless you count LIFO as basically a tax measure. Some countries allow special valuations, reserves and adjustments for inventories and other assets. The Task Force on Business Taxation estimated underdepreciation of $10 billion in industry overall for 1970 alone in considering inflationary effects up to that time. This condition has undoubtedly worsened with the high inflation level in subsequent years. Replacement cost depreciation for fixed assets is certainly a lively subject these days for financial reporting, but there is little reaction from the government for its acceptability for taxation purposes. The New York Stock Exchange study indicates that, after adjusting for inventory profits and underdepreciation based on historical costs, effective corporate tax rates on pre-tax profits for 1973 and 1974 were about 66 percent as contrasted with the statutory rate of 48 percent. In fact, the Exchange estimates on this inflation adjusted basis that in 1974 business actually paid a portion of its dividends out of capital.

Capital gains. No other major industrial country imposes a maximum long-term capital gain tax as high as the U.S. Only Canada and the U.K. have capital gains tax levels comparable to ours. Yet the reformers press for taxing capital gains as ordinary income despite the fact that the system is still another form of double tax on earnings, that the gain is often due to inflation and that unequal treatment would apply to losses. It is probable Congress will extend the required holding period to one year from the present six months' term. On the other hand, the Administration has proposed a sliding scale of exclusion after the one-year holding period—50 percent of the gain up to five years, increasing to 70 percent after twenty-five years.

Foreign subsidiary earnings. U.S. tax law has been constantly whittling away at the economic neutrality concept. Other countries for the most part exempt foreign based income or allow tax credits. No other country penalizes foreign earnings, as has been proposed in recent months, through the taxing of unremitted foreign earnings. Sound taxation concepts should preclude double taxation, allow foreign tax credits at the higher of U.S. or foreign tax rates, and provide for deferral of tax payments until such time as income is received through distribution. To impose taxes earlier would impose a penalty and a bias against foreign investment.

Incentives for investment and savings. The U.S. has no real incentives for direct investment, while other countries exempt certain types of income and grant special write-offs and allowances. A few years ago, the Administration called for new tax proposals to stimulate research and development of new industries and technologies. Such development can be best encouraged by additional tax credits for at least part of the cost. The rapid amortization program enacted for anti-pollution equipment has been made unnecessarily complex and limiting and in part contradicts the flexibility of the ADR capital cost recovery procedure. If our national policy is to ensure the highest quality and safety for our environment, why not make the expenditures required of business simply tax deductible as incurred?

Double Taxation of Corporate Income

As you know, we have a double taxation approach to corporate earnings while all other major countries have some form of relief from such impact. In the jargon of our tax experts, the U.S. system is known as the classical or separate method; i.e., tax is imposed at the corporate level without regard to dividend distributions. These distributions are then separately taxed to the recipient. The classical system, however, conflicts with stimulating equity investment and tends to give foreign competitors an advantage especially where consumption-type taxes (VAT) are a major source of tax revenue. Moreover, our system tends to discourage dividend distributions. For this reason, penalty taxes have had to be devised to deal with "unreasonable accumulation" of corporate earnings.

None of our major industrial competitors—Germany, Japan, the United Kingdom or France—use the classical system. These nations, along with Canada and a number of other industrial countries, utilize either a split-rate or an imputation system. Both methods tax business profits at lower overall rates than the classical system and thus make corporate stocks a more attractive investment.

Split-rate system. This system taxes retained profits at a higher rate than those which are distributed. In theory, the tax rate on distributed profits could be as low as zero. In practice, however, it is somewhat larger. The maximum rate in Japan, for example, is 40 percent for undistributed profits and 28 percent for distributed profits or an effective 34 percent rate assuming dividend distribution of one half of earnings. Advantages of split rate are the reduced taxation at the corporate level, its flexibility for modifying tax policy, and incentives for distribution of earnings.

Imputation system. Under this system, the shareholder receives a direct credit against personal tax liability for the taxes paid at the corporate level. Generally, the credit is the portion of the corporate taxes applicable to the distributed earnings, typically less than 100 percent of the corporate tax. The U.K., for instance, has enacted a basic corporate tax rate with a credit to the shareholder equal to about one half of dividend distributions. This means the shareholders, as a group, would get a credit of about 50 percent of the tax paid by the corporation if all after-tax profits were distributed. As in most imputation systems, the "dividend income" of the shareholder includes the tax credit allowed, in addition to the cash received. For example, if a cash dividend of $100 is received and a tax credit of $50 is allowed, the shareholder will gross-up the two amounts and report dividend income of $150.

Dividend deduction method. Another and differing system, the dividend deduction method, is considered by many as the best suited to the U.S. Under this method, dividends paid, or a percentage thereof, are deductible in computing the paying corporation's taxable income. Although closely related to the end result of the split-rate method (the overall effective tax rate is reduced by dividend distributions), the concept and technical aspects differ considerably. Even though it is not used by any of the major countries, it is the avenue through which many believe relief from double taxation may most likely be achieved in the U.S.

Assuming the same basic tax rate—50 percent, for example—all four of the systems impose the same tax burden on the funds retained. The split-rate, imputation, and dividend-deduction systems, however, pass to the shareholder a bigger after-tax share of dividends than the U.S. classical system.

Dividend Taxation Proposed for U.S.

The Administration has recommended to the House Ways and Means Committee a combination system of dividend deduction and stockholder credits. As proposed, the plan would be phased in over several years to lessen the impact of tax revenue reduction. In the ultimate application of the plan, a corporation would pay the normal tax on earnings less a deduction equal to 50 percent of dividends paid to stockholders. The stockholders would gross up their cash dividend received, by the amount of such 50 percent corporate deduction, and take a direct tax credit equal to such amount. The net effect would be an elimination of double tax.

The Administration's proposal arrives at the right solution. However, some experts believe the procedures involved in the combination of dividend deduction and tax credit would be extremely complex for the millions of shareholders involved. Their recommendation is for initiating only the dividend deduction system at the corporate level.

Regardless of the form of business organization, individuals' taxes would be levied on income received. The choice of corporate financing, whether debt or equity, would also be neutralized, thus removing the present bias from a tax viewpoint toward debt financing. Most important politically is the neutrality achieved among individual taxpayers. Dividends received would be fully taxable to recipients at their respective rates. This is not to say that the deduction system has no disadvantages. It does tend to penalize the developing corporation which needs to retain funds for expansion and would likely encourage a higher level of dividend payment for other corporations. However, it can be argued that such a system would increase the total supply of savings or capital for reinvestment by the individual. For those interested in reviewing the differing systems of eliminating double taxation on dividends, the AICPA's Statement No. 3 of Tax Policy contains a comprehensive discussion of the subject.

Tax Policy and Flow of Capital Funds

There are hopeful signs that both Congress and the Administration recognize the need for rethinking tax policies on a long-term basis if we are to increase sharply the flow of capital funds. The major areas to be considered, in addition to the basic tax rate and deductibility structure, should be capital recovery allowances, bearing in mind the escalating costs of replacement; elimination of double taxation on dividends; direct investment and savings incentives (such as initiated in a limited way with Employee Stock Ownership Plans) and modification of capital gains tax. Whatever the political realities at the moment, this country's taxation policies need to be redirected if we want to improve the availability and flow of capital investment.

Accounting and Disclosure Policies

Now to turn to comments on the impact of accounting policies on invest-

ment. Accounting wields an important influence in our country because of its significance, among other things, in determining corporate profits and taxation revenues—key factors in the economic climate. It seems clear that a fundamental goal both of the private sector and government is to achieve reasonable economic and social stability and smooth out, or at least minimize, those disruptive cyclical swings characteristic of our economy. This goal should be considered in the formulation of accounting objectives and policies and effort made to avoid unnecessary or unrealistic distortions in periodic income measurement. The credibility and utility of accounting policy will be largely tested not by reference to its theoretical niceties but by how well it reflects the substance of business planning and operation.

Anyone who doubts the influential role of accounting in our country need only be reminded of the imminent Congressional hearings by Senator Metcalf's subcommittee. These hearings are intended to probe into the activities and structure of the accounting profession as a whole, the Big Eight firms, the AICPA, the FASB, and several relevant government agencies. At stake may be whether accounting principles will continue to be set in the private sector.

The financial reporting system in the U.S. is generally regarded today as without equal in the world. The wealth and depth of financial information available for a publicly held company in the U.S. is simply tremendous. Much of this vast disclosure lode (some spell it one way, others differently) followed the Securities Acts legislation of the early thirties. Before that the profession and notably the New York Stock Exchange struggled hard to improve reporting, and there were improvements in those days—initiation of published quarterly earnings, increased incidence of annual audits, expanded disclosure of accounting policies and valuation bases. The Bulletin "Uniform Accounting" prepared by members of the accounting profession and banking industry and published by the Federal Reserve in 1917 was one milestone in those earlier days. The report, "Audits of Corporate Accounts," by the Committee on Cooperation with Stock Exchanges was another early effort by the private sector which contributed to strengthening the reporting and the auditing processes.

Nevertheless, the tidal waves resulting from the stock market crash and the great depression so completely overran confidence and credibility in financial reporting that there was little effective resistance to the new securities legislation and the new reach of government regulation. In fact, in many ways, this period was the foundation of the super-regulatory era we have today.

It would be easy and popular to put down the regulatory process in financial reporting. Some knowledgeable people have devoted a great deal of study and writing to advancing the hypothesis that the flood of disclosure dictated by the Securities Acts and by the SEC, for example, may not really have enhanced reliability or aided performance by investors. These views challenge the effectiveness of the regulator and assert the need for more careful analysis to underpin new proposals and to check on the efficacy of existing regulations.

I must say I cannot accept conclusions that indicate little or no benefit from the regulatory process. I include in this process both government and the private sector. I believe that while there have been setbacks and abuses, for the most part developments in financial reporting have been supportive of investor confidence and new capital formation. Beyond the continual refinement and

expansion of legal and accounting disclosure following adoption of the Securities Acts, the regulatory aspects have generally created a heightened awareness and incentive on the part of the security issuer and the seller for a diligent and careful presentation of financial information.

We only need turn to the municipal securities market at the present time to note the clamor for prospectuses and disclosure along the lines we have become routinely accustomed to in corporate offerings. Recognizing that someone may be able to demonstrate twenty years from now that the investor was no better off with additional disclosure of a municipality's finances probably does not sound very convincing at the moment to those holding New York City bonds or notes.

Whether or not we believe this burgeoning disclosure process has helped the investor and capital formation, there are limits, nevertheless, beyond which additional disclosure requirements can be viewed as unreasonable and unnecessary. Those critics of the disclosure process are on target with this point. Extension of disclosure requires sound and tested justification rather than novel theories of the regulator. Much of today's problem with expanding disclosure stems from the duplicative effort and expense to present information calculated under alternative accounting bases—the "as if" type of accounting. Apart from the confusion of differing sets of data, it is frequently not feasible to place such alternative information on a fair and complete basis because earlier underlying business decisions might well have been different if the new assumptions or accounting requirements had been applied contemporaneously. It is a cardinal rule of pro forma presentations, caveats notwithstanding, that pro formas can be misleading if *all* conditions and assumptions are not taken into account.

Problems of European Companies

Based on recent discussions with officials of several large European companies, it seems some of them have lost interest in stock listing or public security issues in the U.S. Most commonly cited as impediments are the generally unilateral and inflexible positions of the relevant agency and the effort and expense to contend with elements of U.S. generally accepted accounting principles in addition to local principles for reporting. The new requirements, for example, relating to foreign currency translation, replacement cost accounting data and auditor review of interim statements are viewed as imposing unnecessarily costly conditions. It is somewhat ironic that at the time these companies were pointing out their disenchantment, the New York Stock Exchange had just released its more liberal requirements to encourage foreign issuers to list on the Exchange.

Multinational Company Problems

Certainly the multinationals, wherever located, are not ranking very high at the moment in the "favorite person" poll. Many government organizations, domestic and international, are crawling over each other to devise and mandate sanctions, codes, and disclosure requirements to suit the purposes of each special interest. The OECD (Organization for Economic Cooperation and Development) comprising the U.S. and 23 other industrialized nations, is probably in the vanguard. Its proposed guidelines are expected to be voted upon by the

member countries next month. The kind of published financial data they want may not seem earthshaking to us in view of existing U.S. practice, but I can tell you their relatively modest disclosure proposals have created considerable controversy and debate over the past year among the OECD members and their advisory groups.

It is also obvious that demands in other quarters are increasing for information on multinational companies. Some demands are for much more detailed data than proposed by the OECD. Within the past few weeks, for example, legislation has been introduced in Congress that calls for the reporting by U.S. companies to the federal government of operating results and other data. Although the requirements are similar to the type of information contemplated by the OECD, unfortunately the legislation would require such data to be provided separately "by each foreign affiliate, by country and by activity." In addition to the substantial cost burden, the questionable utility of such details, and the concern over risks of exposing sensitive information to competitors, there are other difficulties inherent in the mass of information proposed for disclosure under this kind of legislation. To start with, it may not be possible for the multinational to obtain the necessary detailed data on some foreign "affiliates" since they are defined on the basis of 10 percent or more ownership. (U.S. accounting requirements for recognition of affiliated company earnings in the financial statements of the enterprise start generally at the 20 percent ownership level.)

A pervasive problem also relates to the many differences in accounting and taxation principles from country to country. In many foreign countries, financial reporting closely follows taxation rules. It frequently is not useful to compare statutory financial filings of a company in one country with filings of another company in a different country. No valid comparison can be made due to variations, for example, in allowable depreciation methods, inventory valuation and other valuation reserves, and write-offs. Additional confusion, suspicion and criticism may result from attempting to compare results of local operations as measured by the enterprise's accounting policies with the results measured on a statutory basis. Nor would separate financial statements of the many subsidiaries and affiliates prepared on the enterprise's accounting basis necessarily provide clearcut resolution of the problem. There are usually significant consolidation adjustments that would require arbitrary allocation as well as the most fundamental question of all—do financial statements in local currency amounts, or after translation for the parent company's consolidation, provide the more useful presentation?

In any event, I believe that those parties clamoring for special multinational reporting should be adequately served by the substantial amount of information presented in annual reports to shareholders and to the SEC. These reports would include some reasonable geographical grouping of operating results and other key data such as proposed in the FASB draft on segment reporting and in the OECD guidelines. There should also be more widespread publication in local language of a company's annual report within those countries where significant operations or interests are involved. I believe the extensive financial information on a U.S. company presently available is not generally appreciated in the U.S., let alone in other countries.

The European Economic Community has recognized the problem of diverse accounting among its member states. Its current proposals are intended to aid the standardizing of financial statement content and disclosure for reports by companies operating in the EEC. The U.N. is also active. It has established a Research and Information Center to collect, analyze and present information concerning businesses operating internationally. The developments in this program should be followed closely.

Inequities in the Regulatory Process

The OECD and EEC proposals have been based on an elaborate process of exposure and study, including acceptance of the views of outsider advisors. I think the FASB also can take credit for its study and deliberation process followed—even if we don't always like the answers produced. Most times in this country, however, the federal regulatory process is quite narrowly based and dictatorial. In fact, some wide-reaching requirements may often result from advocacy by a single member of a regulatory body, or even by a single person on the staff. It is true that administrative proceedings require a public exposure and comment period, but if one were to view the SEC in recent times, for example, it is questionable how effective this exposure period has been for private sector interests. Within the last few weeks, for instance, the Commission has announced its new requirements for disclosure of replacement cost data as supplemental information to financial statements. Companies will soon need to incur substantial costs to develop the information on a new and completely different accounting basis in addition to that regularly applied.

Much can be said in highly inflationary periods to support an accounting model that reveals the impact on operations and investment from inflation as contrasted with displaying solely the effects of historical amounts. There is no question the accounting profession here and elsewhere in the world is in tune with this general objective. Its methodology and implementation requires resolution. In my view, however, the SEC's recent action is precipitous and unjustified. Many comments received in the exposure process urged the need for a coordinated program of study and experimentation for such radically new concepts in order to preserve some degree of comparability among companies. Substantive comments were furnished to the SEC by many demonstrating the incompleteness of its requirements to reflect properly inflation effects on the enterprise. (By way of contrast, the FASB in its inflation accounting study has been able to enlist a large number of major companies for testing out the proposed concepts.)

Concerns and criticisms have also been voiced in the United Kingdom over the Sandilands committee recommendation for adoption of current cost accounting. At least two years will be available there for study and experimentation before any requirement might be imposed. Because of the SEC's crash program, I think we may have missed a great opportunity to join all the issues on an international accounting basis. It would seem the U.K. situation and the emerging Netherlands disclosure could have offered real possibilities for broad-scale resolution. Instead we are faced with the probability of new conflicts and differences among national groups and accounting requirements, not to mention

the additional burden placed on those companies which must comply with the differing requirements of more than one jurisdiction.

A great deal more could be said of the regulatory impositions on reporting companies. The principal point, however, is that the agency or the government must find a better way of assessing need for and the benefits to the public of their proposed programs. Applying intuition and motivation of a few regulatory officials has resulted in piling disclosure upon disclosure. As Professor Stegler says in his "The Citizen and The State": "Each year the appropriations of each regulatory body grow about 8% on average: 1% for population, 5% for prices and 2% for growing evil. The momentum of events is awesome." You also may have noted the finding of two Stanford University professors in a recent study. They say we have now reached the milestone of having over one-half of the U.S. work force engaged in some form of information gathering and processing.

It may be that those agencies primarily concerned with the financial reporting process should maintain advisory committees, with representatives drawn from the private sector, in order to help achieve a balanced and objective viewpoint in the development of new proposals as well as subsequent periodic review of existing regulations. There needs to be greater involvement of those parties being affected by the regulatory requirements. Agencies tend to follow the concept of "let the private sector prove our proposal is wrong" rather than the agency's shouldering the burden of proof that a proposal is really needed and can be cost/benefit justified. Then, of course, under the agency's approach of "prove us wrong," it is less than fair that the agency acts alone as judge and jury in reviewing the evidence submitted by the private sector.

Moreover, after a regulation is issued, new interpretations by the agency creep in resulting in further unjustified requirements. The comprehensive study of the entire corporate disclosure system recently announced by the SEC may be an encouraging sign. While its objectives may be more broadly based, I hope the study might also stimulate a challenging look at Regulation S-X and other rules which have not had a good sifting out of trivia in years—for example, the endless details of stock option information and the SEC's antiquated policy for separate parent statements in addition to the consolidated statements. Let there be a truly objective assessment of how much disclosure is needed by the "average prudent investor," short of drowning in confusion from overly technical material and alternative presentations of financial details.

Role of the Private Sector

It is equally essential that the private sector continue to take an ever-diligent role in constructively evaluating and articulating its views as to the usefulness and practicality of new proposals. This contribution cannot be effectively made by mere protest. The role of business and other groups in the development of financial reporting must recognize the differing views and needs of the various parties at interest. Response to proposals needs to be supported by hard evidence which in many cases can only be achieved by actual experimentation and display of the reasonableness or the impracticability of the proposal.

It often will be advisable to communicate these views to members of government apart from a particular agency that may be involved, and also to the

financial and business community at large. It will take a highly organized and skilled approach to maintain the financial reporting process on a basis providing reasonable benefits to *all* segments of the community.

Conclusion

Evidence and commentary point to serious concerns with the availability of capital for desired investment goals in the next decade. A leading investment banker, for example, has estimated that to arrest deterioration in the quality of corporate credit, for some years there will have to be a net increase in equity financing of more than $20 billion annually. This compares with half or less than that amount achieved in the past two years.

The significance of accounting policy and disclosure should not be underestimated. The current interest in multinational operations underscores the lack of understanding concerning the differences and limitations in accounting principles and financial reporting. Indeed, more apparent than ever is the need for international standards of accounting and a better balanced program for government's regulatory process.

Finally, the reassessment of U.S. tax policies is critical to an effective program for stimulating capital formation and equity financing. As Secretary Simon stated in his presentation to the Joint Economic Committee of Congress:

> First and foremost we must have a much greater understanding on the part of the public on the basic concepts of capital. Capital is the cornerstone of increased productivity, of higher real wages, of greater job opportunities, of a strong competitive position internationally, and of holding down the rate of inflation.