1-1-1976

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Recommended Citation

Auditing Symposium III: Proceedings of the 1976 Touche Ross/University of Kansas Symposium on Auditing Problems, pp. 074-077;

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

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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 accounting 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.