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Toward a Philosophy of Auditing

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Some may be wondering what more anyone can possibly have to say who has already used two hundred and forty-eight pages of fairly fine print to discuss the philosophy of auditing. This troubles me a little also. The assigned topic may imply that all those pages didn't take us in the right direction. But there are also some advantages in the wording of my assignment. "Toward" is a vague kind of direction, so with such a guide one might be excused if he appears to wander somewhat, and "philosophy" is a word subject to varying interpretation as well.

To refresh myself, I referred to my dictionary and found the following definition of "philosophy":

- 1) The inquiry into the most comprehensive principles of reality in general, or of some limited sector of it, such as human knowledge or human values
- 2) The love of wisdom, and the search for it.
- 3) A philosophical system; also, treatise on such a system.
- 4) The general laws that furnish the rational explanation of anything: the philosophy of banking.
- 5) Practical wisdom; fortitude, as in enduring reverses and suffering.

And then two definitions noted as "archaic":

- 6) Reasoned science; a scientific system: natural philosophy.
- 7) The sciences as formerly studied in the universities.

This provides quite a range doesn't it? An attempt to establish a fairly specific or limited topic with no more boundaries than those provides so little restriction that almost anything qualifies.

I have tried to reduce it to reasonable dimensions by using my earlier work with Hussein Sharaf as a base, and by trying to tie to what appear to be some current problems. The result combines two quite different kinds of efforts; first an attempt to develop a concept of responsibility that meshes with, or at least is not in conflict with, the concepts of evidence, due audit care, fair presentation, independence, and ethical conduct, which we explored in our *Philosophy*; second, an emphasis, using a "practical wisdom" approach, on something of a personal philosophy for auditors, that is, a way of viewing what our essential responsibilities as auditors are. Thus, the paper centers on two major questions:

- 1) To whom are we responsible?
- 2) For what are we responsible?

To Whom Are We Responsible?

The Traditional View. Two conflicting views appear to exist. Traditionally, auditors have considered themselves responsible to the client company as represented by its management. Auditing engagements have come primarily through management. It is the management of the company that makes the arrangements with the auditor to provide audit service.¹ If one goes back far enough, he finds ownership and management identified in the owner-managed company. As companies grew larger and the idea of professional management took hold, a separation between ownership and management appeared, a separation to which many independent auditors may have given less attention than desirable.

Largely ignoring that separation, auditors continued to make audit arrangements with management. At the same time, an increase in the extent of tax and management advisory services plus the emphasis upon constructive auditing, that is, the desire to be of positive help to the client as well as to offer an opinion on financial statements, may have led to an inadvertent identification by independent auditors of the interests of management with the interests of the company. In some cases, perhaps in many, this resulted in efforts to be of as much assistance to the management of client companies as possible.

In many engagements, management is the only interest in the company with which the independent auditor has significant contact. True, the auditor may be invited to the annual meeting of the shareholders, but in appearing there his position is likely to be as an aid to management to answer questions by shareholders and to strengthen the representations of management about the reliability of the financial statements. Certainly in closing conferences on independent audits, unless the company has an audit committee composed of non-officer directors, any discussions of accounting problems are likely to be settled between management and the auditor. Insofar as auditor-client relationships are concerned, in many cases one has difficulty in distinguishing these from auditor-management relationships.

A Competing View. Recently, however, quite a different point of view has been expressed. It may best be summarized, perhaps, in the expression, "The public is the accountant's only client in the world of today."² This assertion recognizes a much larger responsibility for independent accountants—and, indeed, a different role for them. It recognizes that there are many users and uses of accounting data, and that many of those users must be regarded as non-insiders. Public shareholders, creditors who are not represented directly on the board of directors, potential shareholders, financial analysts and fund managers, representatives of labor unions, government planners who rely upon financial statement data as a basis for their prognostications, and members of the general public, all have an interest in financial statements. Yet many of these have no way of assuring themselves that the financial data presented to them are useful or reliable other than to depend upon the services of independent certified public accountants as expressed in audit opinions. This leads some writers to contend that the dependence of these people on CPAs creates a client-type relationship between the auditor and the public.

Those who emphasize this new and expanded role for independent auditors are quick to point out that financial statement data are an important basis for

resource allocation and that the social importance of the nation's resource allocation is such that the work of accountants must be considered to have a strong public interest. They argue that although the audited company pays the bill, the accountant's responsibility runs more to the public and to those outside the company than to the company's management.

Which view is right? There is a great deal of difference philosophically, and I think practically as well, in this emphasis on the public service aspects rather than the client-management aspects of audit responsibility. Let us turn first to an inquiry as to the nature of the client-professional relationship in general. Perhaps we can find some indications here that will help us come to a conclusion.

Nature of the Client-Professional Relationship. With only unusual exceptions, the services of professionals, whether accountants, lawyers, doctors, architects, or others, are obtained on the initiative of the client who selects the professional, has some control over the scope of the engagement, and can terminate the relationship at will. The professional has a direct, contractual relationship with the client and owes the client a degree of loyalty that requires him to resign the engagement if he cannot avoid conflict between the client's interests and the interests of anyone else to whom the professional has a competing responsibility. We find this, for example, in the lawyer's refusal to serve contesting clients and in our own rules about confidentiality.

In the typical situation, the client who has selected the professional compensates him for his work. The relationship is not exactly an employer and employee relationship although there are some similarities. The professional maintains that his expertise not only qualifies him to make independent decisions about the method of accomplishing his objectives, but requires him to establish and maintain a degree of independence from his client in order to be of maximum service. Thus, he is willing to discuss the scope of the engagement in broad general terms but refuses to be limited by a specification of detailed procedures imposed on him by the client.

By no stretch of the imagination does "the public is our only client" notion fit this pattern. Members of the public do not choose the independent auditor, they have no control over the scope of the engagement, they cannot terminate the engagement, nor do they compensate the auditor for his services.

But, then, neither does the notion that management is the auditor's client fit the situation either. In some cases, a company's management may indeed select the auditor, discuss with him the extent of his examination, make arrangements for compensation, and may even be in a position to terminate the examination. But, in so doing, management operates not as an independent user of the auditor's services, but as a representative of the company. It is the company's funds that compensate the auditor, not the management's. Other interests in the company require that the services of the auditor be obtained, and they benefit from those services as much as does management. In more and more cases we see evidence of this relationship as independent auditors are elected, or at least ratified, at shareholder's meetings, and as audit committees made up of non-officer directors work closely with the independent auditors in the development of audit programs and review of the auditor's conclusions.

Ultimately, it is the shareholders who are "the company." Either directly

by them or through their representatives, independent auditors are selected, instructed, compensated, and, if necessary, the audit relationship terminated.

As with the work of other types of professionals, a CPA's services are beneficial to people other than his direct client; they are something of a social good. The nature of his service induces others to rely on financial information, and such reliance leads to financial decisions. If the service is found to be misleading or substandard, a liability on the part of the auditor to others who are not directly his clients may result. CPAs are not the only professionals to face such a possibility. It is not unheard of, for example, for the relatives of a deceased patient to sue the doctor, or for the relatives of victims in a building failure to sue the engineer or architect.

The fact that some type of obligation runs from the professional to people other than the professional's client is not the same thing as establishing a client relationship, however real that obligation may be. If an expression like "the public is our only client" is intended to remind us of this kind of relationship and of the social responsibility of professionals in general, one cannot quarrel with it. However, as a statement of audit responsibility, it is grossly in error and at odds with reality. Further, it may well be a virtual invitation to those who would impute additional responsibility to public accountants.

Some there are in the profession who feel that the independent auditor's burdens are already overwhelming in their potential impact and out of proportion to what he can bear. An open invitation to an unknown number of people with whom he has no direct relationship to consider themselves to be his client with the rights and privileges thus implied borders on the reckless.

The Auditor's Varying Responsibilities. To follow this up a little, note that the CPA has responsibilities to a variety of interests and these vary in extent and nature. He is responsible to:

- 1) Shareholders. Here the client relationship is at its strongest. He owes to the shareholders his primary loyalty including the duty of maintaining confidential anything that would work an injury to their best interests. [But see (2) and (5).]
- 2) Management. The CPA has a derivative responsibility to management. The interests of management in the CPA's activities derive from its position as the authorized representative of the shareholders. To the extent that management's requests to the auditor benefit shareholders and do not infringe on the auditor's necessary independence, the auditor should consider them. Improper activities by management, that is, those which injure the interests of the shareholders, are diametrically opposed to those which benefit shareholders.
- 3) Creditors. Two kinds of creditors can be distinguished: those with a present financial interest and commitment to the company and those with only a potential interest. Surely the auditor's responsibility should not be the same for these. In the one case, there is a real existing financial commitment; in the other there is no more than a possible commitment. Reality and possibility are not the same. A major loan by a bank may be so important to the company and to the bank that all parties at interest agree the bank's relationship is such that it is to have periodic reports of information not provided to others. A contention that such a creditor should be considered to have no rights

to information any greater than the rights of potential minor trade creditors is to ignore both reality and equity.

- 4) Potential shareholders. Like potential creditors and for the same reasons, potential investors have a claim on the auditors but a more limited one than that of present creditors and investors. To potential investors the auditor owes the responsibility of professional quality work in his examination of financial statements and the opinions he issues thereon. Potential investors have the right to rely on the auditor's opinion and to the extent that it is unreliable because of his substandard work they may have some cause for action against him. They do not have any right to instruct the auditor, to make specific demands upon him, or to influence his selection.
- 5) General public. If the general public has an interest in the work of auditors separate from that of potential creditors and investors, it must be that they expect the auditor, as a licensed and acknowledged professional, to have appropriate consideration for the public good in all that he does. As a minimum this would mean that the auditor would provide no support of any kind for illegal acts or their concealment.

Conflicting Responsibilities. It is not difficult to conceive of situations when the independent auditor's responsibility to one of these interests might conflict with his responsibility to another. Let us take an extreme case, one in which the management of the company has engaged in an illegal action for the benefit of shareholders. In *The Wreck of the Penn Central*,³ its authors point out that the Penn Central management was unlawfully involved in attempting to establish an air transportation system in violation of the 1958 Federal Aviation Act which prohibits rail carriers from doing so. Later, the company was fined a total of seventy thousand dollars, allegedly the second largest fine in CAB history.

Now without expressing any views at all on responsibility for discovering such a development, let us assume that independent auditors learned of this activity, knew of its illegality, but, because of their ethical rule requiring that they keep all matters confidential, felt constrained to make no public mention of this. Given the size of the Penn Central, it is quite likely that the potential fine would be considered immaterial. What should the independent auditors do in this situation?

Does the established professional rule requiring confidentiality define appropriate conduct, or can society expect and require something more of auditors? Let me suggest as a tentative conclusion that in a situation of this kind, one in which a company's management is clearly in violation of the law, that management has little, if any, right to claim the loyalty of the auditor. In such cases, may the auditor's loyalty run to another audience? May not society expect the CPA, as part of his professional responsibility, to have concern for all interests, to take into account the specific circumstances, and to give wise professional consideration to the relative rights of all those interests? No single set of rules can cover all possible cases of conflict among those interests. The auditor must have in mind certain general principles regarding the nature of his responsibilities to each of these interests. Given those principles, he must then be prepared to apply "situation ethics" in arriving at a solution to any given conflict.

Summary of Auditor Responsibilities. To whom then is an auditor responsible? To a variety of interests and in a variety of ways. His first responsibility

runs to the present shareholders of the company under examination. In serving them adequately he should supply whatever service to management that is requested and can be provided without violation of his obligation to others. To those others, an auditor has an obligation to perform in accordance with reasonable professional standards and to refuse to condone any actions that are in conflict with established laws or accepted moral standards. This may require that he withdraw from an engagement if he learns of illegal or even immoral acts. In my opinion it would not require that he hold a press conference to disclose it to the world.⁴

My conclusion is that management is not the auditor's client. Neither is the general public. To steer a course that gives proper respect to the relative rights of all the several interests in the auditor's work is not an easy one, but it is the kind of responsibility that can rightfully be expected of professionals.

For What Are We Responsible?

This question is inseparable from the preceding question because in discussing the extent of responsibility which auditors have to the various interests in the company, the nature of that responsibility could not be avoided. Now, however, I would like to explore the question from a different point of view. Let me suggest that the independent auditor is responsible to all interests in his work for:

- 1) Professional competence.
- 2) Independence.
- 3) Authority.

Professional competence has two aspects: technical competence and "social competence." Technical competence includes (1) a knowledge of accounting principles, (2) an understanding of the theory of evidence, which covers the matter of auditing standards, auditing techniques and procedures, and their application in specific situations, (3) an understanding of internal control, and (4) the procedural expertise to perform the steps in an audit program, prepare adequate work papers, develop audit programs, and review the work of subordinates. These are all matters which have been discussed elsewhere and to which I will devote no further attention now.

The Responsibility for Social Competence. Another type of competence at least hinted at in my preceding comments might be described as "social competence." It includes at least three aspects. First, the socially competent auditor must appreciate the role of auditing in the economy. He must accept his task as something more than just getting his client past the Securities and Exchange Commission requirements. He must view his role in the broad sense as an essential step in the allocation of resources and as a factor in the financial decisions of unknown people and organizations. The auditor has an obligation of some sort to all who benefit from allocation of the nation's resources through the functioning of the investment market mechanism, an obligation to avoid any sympathies with the company's management or its shareholders that would permit him to find unrealistic financial presentations to be fair.

He must constantly balance his responsibility to the shareholders against his responsibility to society generally. In the same way, he must recognize that a great many individuals stake their personal fortunes on investments in the com-

pany. He also has a responsibility to balance his obligation to present shareholders against his obligation to potential shareholders and to avoid any unfairness in serving either one of these at the expense of the other.

Social Competence and Competition. Another aspect of social competence is that it is unavoidably affected by one's attitude toward competition. In this country we are strong believers in the benefits of competition. Those benefits run to the services of professional practitioners as well as to business activities. But like so many forces, competition is a good thing only within reason. No, I am not about to take a position on competitive bidding. My interest is of another kind.

Public accounting is a highly competitive profession. On the one hand, this competition undoubtedly urges both individual members and firms in the profession to higher standards of performance, in their desires to retain and attract clients, than might otherwise exist. Unfortunately, an opposite result is also possible. The competitive pressures upon independent CPAs as company managements "shop for accounting principles" could, at least in some cases, result in *lower* rather than higher standards. If we look closely at the nature of competition among public accounting firms we see that it can be effective on three different levels: at the levels of price, of principles, and of service.

Competition on the basis of price is in some ways unfortunate, but it is impossible to avoid. For instance, price competition is within the scope of what the Department of Justice considers desirable, as indicated by recent actions of the Department.

Competition in the matter of accounting principles, if deliberate, should be regarded as almost unforgivable. To the extent that it does occur, it probably is not intentional but rather is an unintended and often unrecognized result of trying to meet the needs of clients in the face of competition from other firms. The ever present knowledge that there are other firms of equal prestige and status that just might see the results of a transaction differently is a specter difficult to shake from the minds of any who make audit decisions.

Competition on the basis of service, to the extent that we can separate service from price and principles, is a good thing and we should be in favor of it. Social competence requires not only that the auditor understand the nature and influence of competition on his decisions but that he discipline himself sufficiently to be constantly alert to its pressures.

Attitude Toward Clients. A final aspect of social competence for the independent auditor is found in his attitude toward his clients. Obviously, he has a responsibility to them to be as efficient, effective, and helpful as he can be. In addition, he fails them in his most important function if he is less independent in the development of his program, in the performance of the work required thereby, and in making audit and accounting judgments than the circumstances require. The auditor also has a responsibility, and a very difficult one, to keep a client's requests and demands in perspective. Certainly there are times when a client's request must be rejected as inappropriate. To the extent that the auditor is aware of and can remember his responsibilities to other interests, he is less likely to accede to requests that have any taint of impropriety.

Is Audit Service an Inalienable Right? Now let me pose two questions which I think are related and rather difficult to answer. First, does an auditor

have a responsibility to avoid unsavory clients? Second, is everyone who needs the services of an independent certified public accountant entitled to obtain those services? I see these two questions to be in conflict. We have, on the one hand, the feeling that auditors will seldom get into any kind of litigation difficulties if they can hold their practice to seasoned and thoroughly reputable companies. On the other hand, companies in the development stage, even those promoted by people with a string of failures, may be considered to have some rights. Certainly they need the services of an independent CPA if a public offering of securities is involved in arranging financing.

One can readily argue that the best interests of the public accounting firm would be to steer clear of any client that might possibly pose financial difficulties. One can also argue that the best interests of the economy require that every promoter be given a chance because we never know when a speculative undertaking may prove to have significant social benefits. Perhaps what we need is something a little like the public defender role played by lawyers. Perhaps some auditors should be designated or assigned to serve clients who otherwise would not be able to obtain the services of a reputable firm. In such cases the "assigned" auditor might require some special protection against litigation.

Another Aspect of Independence. Independent auditors are required to be independent. In this tautology we find one of our most complex concepts. I do not plan to explore it fully here. In their excellent work, Messrs. Carey and Doherty distinguish the self-reliance required of every professional from the special meaning of independence to the CPA.⁵ Both Mr. Higgins⁶ and Mr. Blough⁷ have emphasized the difference between real independence and apparent independence and found both of them significant. Sharaf and I distinguished practitioner independence from profession independence.

To complicate things a little further, let me experiment with two terms which are useful in pointing up another problem related to independence. "Operational independence" was used in our earlier work to describe the kinds of freedom which an auditor must have in developing his audit program, in performing the various verification procedures required by it, and in preparing his report. Without these freedoms he cannot be considered independent. "Attitudinal independence," that is, the state of mind which leads an auditor to be objective in all his decisions, is no more than another name for the traditional "state of mind" description of independence already so well expressed in our professional literature. To be truly independent, an auditor must have both operational independence and attitudinal independence.

Operationally, the freedom to develop a program, to perform it without interference, and to report on the results of that performance is not enough. One must also have sufficient knowledge to utilize that freedom effectively. The less one knows about an industry or about a company the more he must depend upon others for guidance. An auditor unacquainted with a specialized industry or an unfamiliar client may have to ask questions and depend upon the responses he gets to those questions in order to make any progress whatever. Such dependence may infringe on his operational independence as effectively as would deliberate interference by company officers or employees. The less one knows about a company or an industry, the more he must depend upon others. The more he knows the less dependent he is. Some degree of intimate knowledge is

therefore important to independence. One can therefore argue that the performance of management services is directly beneficial to the auditor in that it helps him to attain a degree of understanding and knowledge that he might not be able to obtain in any other way.

Apparently opposed to this is the position we took in our *Philosophy* that auditor participation in the performance of management services may infringe upon the auditor's attitudinal independence. Attitudinal independence requires that the auditor avoid identification of his goals with those of the company and its officers. Any activities that bring him into a more intimate relationship with the company or its personnel may lead him to identify with them, to sympathize with their problems, to view the welfare of the company and the attainment of its objectives as taking precedence over his responsibilities to others. Such identification unavoidably infringes upon attitudinal independence.

Which side do you wish to take? I find myself torn between the two. My good friend, Walter Frese, argues with me that the performance of management services is desirable because it helps the auditor to understand the position of management and therefore to avoid that degree of dependence which ignorance strengthens. My personal inclination is to argue strongly in favor of maintaining attitudinal independence for the auditor and requiring that the extent of audit work be strengthened or expanded sufficiently that true operational independence is possible.

Audit Authority. Those of you who have lasted this far may have noted that I seem to be getting myself into deeper and deeper trouble as I proceed. This last item continues that unfortunate trend. In responding to the question, "For what are we responsible?" I introduced the idea of authority. The independent auditor is responsible for the exercise of authority. I must confess to some reservations about this choice of words, but at the moment have no better one to offer.

Authority has been defined as "the power to command and enforce obedience." Given this definition, what authority does the individual CPA have in the performance of an audit? Our conclusion must be that his authority is tenuous at best. This follows from the nature of the client relationship as well as from our insistence that the financial statements are the client's. As pointed out earlier, the CPA-client relationship is a voluntary one and can be suspended by either the client or the CPA. Hence, if the client feels that he is subject to too much control or authority by his independent auditor, he can terminate the relationship. The initiative is with him to continue or to terminate. Likewise, the fact that compensation flows from the client to the CPA almost unavoidably has some impact. In addition, we have established the position that the financial statements are representations of the client and, as such, that he should have the final decision as to what they will or will not say. This combination of circumstances does not necessarily rob the independent auditor of all "power to command and enforce obedience," but it serves to reduce that authority in a good many individual cases.

Now let us turn to the authority of the CPA profession. Here we find a considerable degree of authority. To the extent that the Securities and Exchange Commission requires that the opinion of an independent CPA accompany the financial statements of a company filing with the Commission, and the listing

requirements of the stock exchanges call for the opinion of an independent CPA, companies are subject to the audit requirements of the profession. I recall a former member of the Securities and Exchange Commission stating that the accounting profession was so vital to business that business could not get along without it. Can you imagine what would happen to a major company if an accounting treatment which its management insisted upon was considered unsatisfactory by *all* CPAs? There seems little doubt but that the company would have to give.

To repeat, then, for the sake of emphasis, the CPA profession has considerable authority. The individual CPA seems to have very little. Therein lies a difficulty.

Perhaps we should give some attention to the question of whether it is desirable that the independent CPA have greater authority. Would we be better off if a company, having once committed itself to a given CPA, had no choice but to accept the CPA's decisions with respect to the presentation of financial statements?

My response to that question is that we would not be better off. I believe strongly that the financial statements must be the company's and that the company should have the freedom to present those financial statements in any way that it pleases. The auditor who finds himself in disagreement with the company's presentation should be expected to so state in his opinion. Is it not conceivable that the company and its auditors could have an honest difference of opinion, one that even after careful examination of all the facts and a thorough understanding of the principles involved might be irreconcilable? In such a situation, are those who use the financial statements better served by a forced agreement, one in which either the views of one or the other dominate or a compromise position is worked out, or would the users be better served by having both presentations made available to them with an explanation of the difference?

What I am getting around to saying is that the time honored policy by the SEC of requiring that qualifications and exceptions be removed from audit opinions may be working to the disadvantage rather than to the advantage of financial statement readers. If the requirement of a clean opinion does force compromise in some cases, if it reduces the total amount of information that otherwise would be available to the readers of financial statements, if it submerges actual and perhaps even justified differences between auditors and company management, is it a good policy?

The purpose of the SEC's policy, of course, is to strengthen the independence of the accountant, and certainly this is important. Can other ways be found to strengthen that independence without submerging useful information?

One source of authority is fear. If I am afraid of a physical beating, I may choose to obey the commands given to me. A company's management may fear an open comparison of its views with those of its auditors. Fear of the withdrawal of its auditor from the engagement may also be effective, particularly if this requires an explanation of the differences between auditor and management at a shareholder's meeting.

At the present time, the auditor's alternatives are limited. If he has a real difference with management, he must take an exception which may well cost him the client and which he has no real opportunity to explain or defend. Alternatively, he can withdraw from the engagement, but here he faces the

same problem in that no one will ever know his reasons. If we could establish his right to report independently of the management, and perhaps even establish a requirement that differences between them must be publicly disclosed, would not his alternatives, his independence, and perhaps even his authority be improved?

Conclusion

By way of conclusion let me confess that for few of the questions raised here today do I even pretend to myself to have final answers. It would be very useful if some authoritative study group would undertake to establish for us the nature and extent of the independent CPA's responsibility to each one of the several interests in financial statements. The tendency to state that "the public is our only client" is a most unfortunate kind of expression, if for no other reason than it implies that we are thoroughly confused about who our client is and what our responsibilities are. It would also be helpful if we could have some extended discussion of whether what I have called social competence is really relevant to the independent CPA's activities.

Perhaps you have had from me very little in the way of "practical wisdom" and a good deal in the way of speculation. I leave it to you to judge. Until we can answer to whom and for what we are responsible, however, we have not advanced very far "toward a philosophy of auditing."

Footnotes

1. In this connection see *Business Week*, March 25, 1972, p. 36 for a note describing SEC consideration of "a staff recommendation that outside directors nominate corporate auditors."

2. See Robert M. Trueblood, *et al.*, "Information for Proprietors and Others," Touche Ross & Co., 1972, p. 29.

3. Joseph R. Daughen & Peter Binzen, *The Wreck of the Penn Central*, Little Brown and Company, Boston, 1971.

4. See Statement on Auditing Procedure No. 41 for the profession's solution to a somewhat similar problem.

5. John L. Carey and William O. Doherty, *Ethical Standards of the Profession*, AICPA, Inc., New York, 1966, p. 18.

6. Thomas G. Higgins, "Professional Ethics: A Time for Reappraisal," *The Journal of Accountancy*, March, 1962, p. 81.

7. Carman G. Blough, "Responsibility to Third Parties," *The Journal of Accountancy*, May, 1960, p. 60.