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Stone, Gray and Company

Most of the other papers delivered at this symposium commence with the word "toward," e.g., Toward Standards for Statistical Sampling, Toward Standards for Materiality, Toward a Philosophy of Auditing. Apparently our chairman had no wish to go "toward" further problems in auditing when he assigned my topic. Consequently, my talk may be described as "untoward." I have thought a great deal about my topic since I received the assignment—so much in fact, that it has found its way into my dreams. Before addressing myself formally to the topic, let me describe a few of those dreams. My dreams are seldom, if ever, in technicolor. Everything is in sharply defined black and white—no gray areas, as in real life.

Dream No. 1—Independence and Fees

The scene of dream number one is a courtroom in which Ralph Nader is presiding judge. As my dream commenced, I was on the witness stand and was being asked to describe the CPA's role. The questioner was a not-too-friendly banker who frequently questions the CPA's independence. In all candor, his question was a little more pointed—something like, "What the hell *do* you auditors do, anyway?"

Casting aside my well-known reticence to speak before an audience, I delivered the following carefully prepared extemporaneous remarks:

> The business community in which all of us live and work is very much like a giant football game. Businessmen play the game. The SEC and we CPAs are the officials—the only difference being that the SEC has a whistle, but the CPAs don't.
>
> The public, watching from the stands, relies on the officials to see that everyone plays by the rules—the same rules. The rules are written to permit a little deceptive ball-handling, designed to fool competitors on the other team, but not to prevent the spectators from determining how the game is going—who is gaining ground and who is losing.
>
> Many of the onlookers don't even know what the game is all about. They just came along to watch because that's what everyone else was doing.
>
> Everyone watching the game is entitled to know that the gains and losses of all the players are measured against the same yard markers.

They are entitled to expect that first-down measurements are all made with the same ten-yard chain, and that all players are battling over 36-inch yards. Even the best binoculars don't provide an observer in the stands with vision equal to that of a person on the playing field. That's why officials are needed.

Its the very nature of things that occasional disagreements arise between the players and the officials. Rule enforcers seldom win popularity contests. And, of course, a few shouts from the stands of "Kill the Ump" are in the best American tradition. In our case, whenever anyone sees an infraction which escapes the official's view, the shouts come out, "Where was the Auditor?"

Like officials at other games, the officials in this game of business are rarely accused of dishonesty, I am happy to say. One hears an occasional derogatory comment about our eyesight or intelligence, but then the right to call an Ump blind or stupid is also part of our American Heritage. Once in a while a particularly incensed spectator may even question the legitimacy of our birth. Unpleasant as it is to hear epithets such as these, all of us—officials and players alike—must grin and bear it. For if the public didn't buy tickets to the game—i.e., if they didn't buy stock in the companies whose statements we audit—there would be no game.

While many of the spectators may just come along for the ride, the majority have a vital stake in the outcome of the game. They have placed heavy bets on one team or another. It's up to the CPA to give those who have a stake in the game the best possible data with which to evaluate the teams.

Naturally, I expected applause, or at least rapt attention interrupted periodically by chuckles of amusement at the cleverness of my analogy. Instead, the judge and jurors exhibited an attitude of obvious skepticism as they shook their heads in disbelief. When I looked closer, I noted that each of the jurors was also a bank loan officer. In fact, it began to look like a Robert Morris Associates meeting.

The examining counsel continued his questioning:

Q. In this football game of business, Mr. Stone, how does it happen that each team hires its own referees?

A. Traditionally, every firm has always had the right to engage auditors (and for that matter, all types of professional advisors) of its choice. The right was questioned during Congressional hearings which preceded passage of the 1933 and 1934 Securities Acts. When a spokesman for the accounting profession was asked at that time who audits the auditors, he replied, "Our consciences."

Q. You're supposed to be independent of your clients. Isn't that right, Mr. Stone?

A. Yes, that is correct. Our code of ethics contains strong rules designed to insure our independence, both in appearance and in fact.

Q. How can you be independent of the client who pays you? Doesn't his right to discharge you in favor of another auditor impair your supposed independence, both in appearance and in fact?

A. No, not at all. We are governed not only by our consciences, but also by a growing body of official pronouncements which provide guidelines to eliminate at least part of the potential areas of disagreement. The possibility that some agrieved party might sue for damages undoubtedly acts as an additional safeguard against the auditor's succumbing to client pressure. As you probably know, no member of the auditing firm may serve as an officer or director of the company to be audited, nor may any member own any interest whatsoever, either directly or indirectly.

My questioner obviously considered my answer somewhat lame and not altogether responsive. He continued by saying:

> Your profession seems to have taken great pains to avoid *minor* infringements of actual or apparent independence. For example, you can't audit a company if even a few of its shares are owned by the wife of one of your partners in Seattle or Miami because *that* might make it appear that you aren't independent. Yet you consider your independence unsullied by the fact that your entire relationship with the client depends completely on his willingness to re-engage you and to pay your fee.

Although these comments weren't framed as a question, I took the opportunity to comment on the growing feeling that the public is really the CPA's client and to describe the AICPA's 1967 statement urging corporations to appoint audit committees composed of outside directors to nominate auditors and to receive their reports. This led to the following additional questions:

Q. Is this AICPA statement binding on anyone?
A. No. It's merely an advisory statement.
Q. As a matter of fact, isn't it true that this advisory statement has had very little effect on publicly held companies?
A. I believe some corporations have adopted the recommendation, but I don't know how many.
Q. How would this recommendation affect the thousands of companies that have no "outside" directors?
A. It would have no effect.

Taking a somewhat different tack, the questioner asked:

Q. Mr. Stone, a minute ago you commented that the CPA's real client is the public. If that is so, why are auditors' reports addressed to the company, its board of directors, or its stockholders? Why not "to whom it may concern" or simply no salutation at all?

After pondering the question for a few moments, I was tempted to quote Tevye, the impoverished dairyman in "Fiddler on the Roof," who when asked to explain one of his people's traditions says, "You may ask, 'Why do we wear our little round skullcaps?' Well, I'll tell you—I don't know."

However, since I had been billed as an expert, I felt obliged to burble a few ill-chosen words to the effect that the apparent inconsistency was merely evidence of the dynamic nature of the accountant's world. I agreed that different wording might well be more consistent with the auditor's present relationship to the public.

At this point, my lawyer took advantage of the rather liberal procedural rules which pervade my dreams and warned me in a stage whisper that eliminating the traditional salutation from the auditor's opinion could well lead to a further deterioration of the *Ultramares* doctrine which requires a greater degree of care by CPAs to their clients than to third parties who have no privity. Easing the seeming distinction between clients and third parties could serve to accelerate that trend.

Then, in a typical display of what for want of a better term I will call "lawyer other-handedness," he said: "But on the other hand, the *Shatterproof Glass* decision may have already buried *Ultramares*." Once again, I yearned for a one-armed lawyer.

Having been thus forewarned (if not forearmed) by my lawyer, I turned my attention back to the examining counsel. He concluded his interrogation with one more salvo:

> Q. Mr. Stone, if, as you say, the public is your client, should not your pay come from the public? After all, he who pays the piper calls the tune.

Before I could respond, I was dismissed and James Needham, a member of the Securities Exchange Commission, was called to the witness stand.

> Q. Mr. Needham, would you describe your professional qualifications.
> A. I am a Certified Public Accountant, and was engaged in the practice of public accounting for a number of years before appointment to the SEC.
> Q. Is the SEC considering the issuance of a recommendation that outside directors nominate the corporate auditors?
> A. Yes, the Commission is considering such a proposal. In its present form, the recommendation would not have the force of law. If adopted, it would amount to a strong nudge.
> Q. Could you tell us why the SEC is considering this move?
> A. We've become concerned about the quality of work performed by many accounting firms. In fact, I've suggested that accounting firms might find it beneficial to reevaluate their current large outlays on professional development in light of the actual audit performance. The SEC has found instances of problems relating to elementary disclosure, succumbing to obvious pressure by clients, faulty judgments and decisions at the partnership level of the certifying accounting firms, and questions of independence bordering on commercial fraud.

After James Needham stepped down, the examining counsel summed up by saying:

> When life insurance companies want to know whether they should bet on my survival, they don't ask *me* to hire a doctor—they send me to theirs. The same thing happens when I apply for a job and the employer requires a physical examination. Perhaps its time for someone other than the contestants to hire the referees in the game of business described by Mr. Stone.

As my dream faded out, I kept hearing the song from the "King and I" in which the King of Siam, musing on what to tell his son and heir about women, and life in general, wonders aloud if he should educate him in all the ancient lies. Then, frustrated at the indecision fostered by his new-found modern knowledge, the King sings: "When my father was a king, he was a king who knew exactly what he knew."

As the King says: "Is a puzzlement!"

Dream No. 2—Audited Forecasts

The second dream I would like to tell you about again found me on the witness stand. This time, however, the examining counsel was a well-known financial analyst. His questions went something like this:

Q. I use financial statements to help predict the future. If you insist on using historical costs, why don't you at least give me a projection for the next year or two?

A. Management is hesitant to divulge its plans, since to do so might aid competitors.

Q. Management must have prepared a budget and cash forecast. Why can't we see them?

A. Management would rather not answer for differences between predicted and actual results. Not only that, unscrupulous managements could adjust predictions to further their own aims. Over-optimistic predictions could be used to generate short-range increases in stock prices. Overly pessimistic predictions could be made public in order to cause actual results to look good by comparison. From the data in an annual report, readers can construct their own forecasts.

Q. What you are giving us then, is a kind of "do-it-yourself kit." That arrangement doesn't seem very efficient. Management and its accountants have the best grasp of the pertinent facts and are most knowledgeable about future plans. Yet they withhold the very data we users need. What kind of full disclosure is that?

Even in my somnolent condition, I recognized this as a rhetorical question to which no answer was expected. Counsel continued:

Q. Do CPAs audit budgets and other forecasts?

A. CPAs often assist clients in preparing budgets and forecasts; however, we don't audit them. Our ethical rules prohibit the expression of an opinion on forecasts.

Q. Why the prohibition?

A. CPAs traditionally report on data that is susceptible to objective tests. Forecasts are based on opinions as to future events. An evaluation of the likelihood of such events occurring and of their probable results necessarily must rely largely on subjective evidence.

Q. You say CPAs aren't permitted to render opinions on future events. Isn't a historical statement full of assumptions about the future? Isn't your examination of receivables and the related provision for uncollectible accounts explicitly directed toward future collectibility? Isn't your examination of inventories concerned primarily with future saleability? Isn't it true, Mr. Stone, that future recoverability of unamortized plant and equipment costs is one of your principal concerns when examining fixed assets? Similarly, isn't future recoverability of primary concern when you examine capitalized research and development costs?

You say that CPAs render opinions only on objectively determined historical costs. Frankly, it seems to me that the line between the past and the future is hazy indeed. In fact, Mr. Stone, isn't it true that the "going concern" concept which underlies the financial statements of every business entity is, in effect, an implied opinion as to the future?

Suppressing a mischievous desire to ask that the question be repeated, I again assumed the question to be rhetorical. Mistaking my silence as a sign of tacit agreement (or at least the absence of any objection) my interrogator continued:

Q. We only consult history to shed some light on the future. Since auditing purports to be a utilitarian art not an academic exercise, why do CPAs audit history but not budgets?

My recollection of how this dream ended is somewhat hazy. I recall examining counsel repeating the last question over and over with ever-increasing insistence. I remember wondering why my lawyer failed to come to my aid by objecting to the questioner's haranguing and argumentative line of inquiry, until I noticed that the presiding judge was one Lewis Gilbert.

Should any of you wonder how this dream sequence ends, a midnight snack consisting of a liverwurst and smoked oyster sandwich on rye and a bottle of beer will produce an instant replay—at least, that's what induced the original.

Dream No. 3—Management Advisory Services and Independence

I seem to have tuned in late on the next Dream, so I didn't catch the questioner's name. As the dream opened, I was again on the witness stand and questioning was already underway. This time, the questioner was speaking in a pleasant, disarming way, with a hint of New York in his voice. He was humming a tune that I couldn't quite place. His questions began:

Q. Mr. Stone, you were saying that audits often result in recommendations to the client.
A. Yes. Most CPAs consider the suggestions for improvement of a client's operations the most important result of an audit—certainly the most tangible.
Q. Are CPAs often engaged to render management advisory services as a result of the recommendations contained in the so-called management letter?
A. That depends somewhat on the nature of the CPA's expertise and his ability to convince the client that consulting services are needed and that the CPA is the most logical supplier of those services. In many instances, CPAs *are* engaged to render the services recommended in a management letter.

Examining counsel continued in a friendly vein:

Q. Could you give us some examples of these services?
A. CPAs are often engaged to improve a client's accounting system or even to install a completely new system. We advise clients how taxes may be reduced by choosing the most beneficial accounting methods for such items as depreciation and inventory valuation. We occasionally assist clients in revising their financial structure to improve working capital or to facilitate expansion. Clients sometimes need help in deciding to buy or lease needed equipment or real estate. CPAs can be useful in that area as well.
Q. Aren't you being too modest, Mr. Stone? I've read that CPAs contribute to client profitability. I've heard them described as a vital part of the management team. Don't CPAs often play an important role in merger, sale and acquisition negotiations?

I cast my eyes downward, blushing slightly, and kicked my foot to the side diffidently as I uttered some modest phrase like, "Aw shucks." Then I proceeded to describe in some detail a few of the more imaginative consulting services I have performed during my professional career. I must confess that even the retelling itself became somewhat imaginative as I warmed to the task. I was feeling positively eloquent by the time I finished.

The euphoria into which I lapsed was interrupted by my questioner. With a sardonic smile on his lips and a somewhat more insistent tone in his voice he asked:

> Q. After performing these many and varied services for your clients, Mr. Stone, are you still independent to report to the public? Can you look objectively at the outcome of a transaction you helped structure? Can you judge the fairness of data accumulated by a system you designed?

Jolted out of my blissful state, I started to collect my thoughts in order to frame a response. The judge, Malcolm Devore, gave me a short respite as he leaned down from the bench to remonstrate my questioner: "One question at a time, Professor Briloff, one question at a time." As I heard my questioner's name, I suddenly remembered the name of the tune he was humming. It came from "The Mikado" by Gilbert and Sullivan and is called, "I Am the Lord High Executioner."

Having regained my composure, I delivered the profession's traditional response:

> A. In consulting engagements, CPAs merely advise; decisions are made by the client.

Judge Malcolm Devore listened with obvious sympathy to my reply, but Professor Briloff was so busy conferring with his co-counsel, Professor Schulte, that he didn't seem to be paying much attention to my answer. The moment I finished, Professor Briloff was back on his feet asking:

> Q. Shouldn't a CPA insure his independence, both in fact and in appearance, by refusing to perform consulting services for audit clients?

I responded with the "party line":

> A. Any such policy would deprive the client of advice from the person best qualified to give it. Forcing the client to engage a multitude of advisors spreads responsibility and diminishes efficiency.

In rebuttal, Professor Briloff commented, "Mr. Stone, your response sounds like an indictment of a separation-of-duties doctrine which is the very cornerstone of every system of internal control."

I was delighted that the judge relieved me of the obligation to reply by ruling Briloff's comments out of order. As the dream ended, the jury foreman (who also turned out to be Malcolm Devore) was applauding Judge Devore's decision.

Dream No. 4—General Acceptance vs. Fairness

I will recount just one more dream before getting to the subject of my talk. This dream opened in a courtroom where the bailiff was intoning the familiar, "Hear ye, hear ye, this court is now in session in the case of General Acceptance vs. Fairness, Judge Henry J. Friendly presiding." Again, I found myself on the witness stand. After the usual preliminaries establishing my professional qualifications, the examining counsel, Wilma Soss, proceeded as follows:

Q. Mr. Stone, the standard opinion rendered by CPAs contains the phrase, "generally accepted accounting principles." Could you tell the court by whom these accounting principles have been generally accepted?

A. By preparers, users and auditors of financial statements.

Q. How do CPAs learn of this "general acceptance"? Does some organization take a periodic poll?

A. The Accounting Principles Board, an arm of the American Institute of CPAs, surveys accounting practices on a continuous basis. As a result of this surveillance and an extensive program of research, the APB issues opinions from time to time. Among other things, these opinions delineate which accounting principles are acceptable and which are not.

Q. Has the APB issued opinions on all or substantially all of the principles which underlie financial statements?

A. No, the body of principles is large and continues to grow as conditions change. Consequently, the APB, its predecessor, The Committee on Accounting Procedure, and the Financial Accounting Standards Board which will soon replace it could never hope to finish the task. The APB and its predecessor have tried to devote their resources to those areas most in need of attention.

Q. I understand that alternative means have evolved to portray various segments of accounting data. When that occurs, Mr. Stone, which alternative gets the APB's blessing—the method with the most followers?

A. Not necessarily. While the APB has attempted to narrow and reduce differences, you should understand that several alternative accounting methods may be considered generally accepted in a given situation, even though they may arrive at different results.

Q. When several acceptable accounting methods are available, which method does the accountant use in a given situation?

A. Hopefully, the one which results in the fairest presentation of the facts.

Q. Aha! You said "fairest presentation." That's the first time that you have said anything about fairness.

A. Fairness is the ultimate aim of all the APB's efforts. General acceptance is merely a means to that end.

Q. Isn't it true, Mr. Stone, that some of the accounting methods in general use fall somewhat short of the fairness standard you describe?

A. I suppose so. However, the APB is trying to weed out the inferior methods.

Q. A moment ago, Mr. Stone, you said that "hopefully" an accountant will use the accounting method which results in the fairest presentation. Isn't the auditor required to insist on the fairest alternative before he expresses an opinion?

A. No, there is no such requirement at present. However, CPAs often exert their influence in favor of the superior method. Perhaps some day the use not only of generally accepted accounting principles but also of the most desirable GAAP will be required before an auditor renders an opinion on financial statements.

Q. On the subject of the auditor's opinion, Mr. Stone, the standard language somewhat confuses me. You CPAs say that statements "fairly present . . . in conformity with GAAP." That phrase could have several meanings. It could mean:

a. The statements are both fair *and* in conformity with GAAP.
b. The statements are fair because they are in conformity with GAAP.
c. The statements are fair only to the extent that GAAP are fair.

A. Your confusion is understandable. A special AICPA committee
Which of these meanings does the CPA intend?
urged some years ago that terms such as "present fairly" and "GAAP" be defined. A survey by Professor Briloff of selected members of the accounting profession and of the financial community showed support for each of the interpretations you mentioned and a few others as well. AICPA literature appears to take the second approach, i.e., "present fairly" is modified by the "conformity" portion of the full phrase.

A fair presentation is to be understood within the framework of GAAP, much as the behavior of football players is to be understood as "fair" within the framework of the rules of football. Just as what is fair in football may not be considered fair in other forms of social activity, meeting tests of fairness within the framework of GAAP does not guarantee meeting such tests from the standpoint of users of financial statements. This interpretation of the phrase might be called the "ground rules" theory.*

Q. Does the "ground rules" approach have the widest support among the members of the accounting profession and the financial community?

A. No, the Briloff survey showed a preference for the first interpretation. This is an understandable reaction from the financial community, but a somewhat surprising reaction from CPAs since it is the least favorable from the legal liability standpoint. Incidentally, for some years, Arthur Andersen & Co. worded its opinions: "Present fairly . . . *and* were prepared in conformity with generally accepted accounting principles," which also infers a meaning similar to the first interpretation.

Q. With so much disagreement among CPAs themselves as to the meaning of key words in the standard opinion, is it any wonder that people outside the accounting profession don't know what an auditor's opinion means?

A. The accounting profession has worked long and hard to improve communication with the public. The profession unquestionably still has a long way to go. Since fair presentation of data is clearly the accountant's major goal, it may well be that the term, GAAP, will prove to be a mere way-station in the evolution of the auditor's opinion. The term may well disappear in time, taking with it many questions of semantics which now bedevil writers and readers of CPA opinions. Should this come to pass, the issues raised in this dispute between "general acceptance" and "fairness" will become moot.

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* See "'Present Fairly' and Generally Accepted Accounting Principles," Geraldine F. Dominiak and Joseph G. Louderback III, *The CPA Journal,* January, 1972, pp. 45-49.

I quickly learned how the judge felt about the matter when he instructed the jury that the critical test in determining if financial statements are false or misleading is whether they fairly present financial position, *not* whether they conform with GAAP. Before a decision was reached, the trial was interrupted by the clarion call of my alarm clock, arousing me to another day of toil in the vineyards of public enlightenment.

Unfortunately, problems with auditing don't stop when I awaken. Here then are a few more of the problems with which auditors must wrestle, awake or asleep.

Need for a Better Defined Philosophy of Auditing

Some years ago, Mautz and Sharaf published an excellent monograph on the philosophy of auditing, a subject on which Bob Mautz will further expound tomorrow. While this work is a good start, I am certain that the authors did not intend their pioneering efforts as a final word on the subject.

Neither auditors nor their clients seem to have a clearcut understanding of the auditor's role. In the area of fraud detection, for example, this uncertainty is evidenced by the fact that many audit procedures seem designed almost entirely to detect defalcations even though auditors continue to deny any responsibility for fraud detection. For many years, the public ascribed occult powers to auditors. Auditors were generally believed to possess near-magical powers to ferret out misdeeds merely by passing their hands over a set of books. Although auditors knew full well that no such magical powers existed, they somewhat enjoyed the effects of these widely held misconceptions and did little to dispel the mystique. Ony recently, have auditors—prompted by a rash of lawsuits—attempted to bring their public image into better focus.

The trueblood Committee's findings (re: the objectives of financial statements) could be a prelude to a similar study of audit objectives. Such a study might well provide a better exposition of just what an audit is, for whom it is performed, etc.

Need to Recognize Auditing as a Discipline Separate from Accounting

Since CPAs have traditionally audited financial statements, the line between accounting and auditing is not at all clear. This haziness is further enhanced by the fact that our reports are traditionally expressed in accounting terms. The need for a better delineation of auditing as a separate discipline is becoming more apparent as CPAs are called upon with greater frequency to audit non-financial data and management performance.

The fuzziness of the line between accounting and auditing has been particularly evident in the protracted attempts to re-word the short form auditor's opinion. Part of the difficulty may, of course, be attributed to a natural reluctance to change. However, the main problem lies in the lack of a theoretical underpinning for the entire field of auditing. Without basic theory, it's no surprise that audit procedures are in a rudimentary stage of development. Drawing inferences from a sample has long been a major technique of auditors. Yet the use of scientific sampling methods to insure validity and permit establishment of confidence levels is only recently making headway among auditors. Many CPAs still view statistical sampling as "organized superstition."

For auditing to come into its own, it must be severed from accounting and stand on its own theoretical feet. This move is particularly important if CPAs expect to be acknowledged as auditors of non-financial data, an important development in my opinion.

By way of example, the decennial census provides data upon which a great many people rely. The census, then, is an obvious candidate for independent audit. Were a CPA to undertake such an engagement, he would quickly find just how intertwined accounting and auditing really are. Few of his questions concerning theory, procedure, or form of report would be answered by any of the present auditing literature.

Need for Current Value Reporting

Without reiterating the current value arguments which were presented at the 1970 Kansas University symposium, historical cost creates problems for auditors, too. The auditor's function is to add credibility. No amount of auditing can make incredible statements credible. To most readers, I fear that the implications of historical cost statements are just that—incredible (and unintelligible, to boot).

My firm audits a company which made a sizable investment in two parcels of land ten years ago. Last year, the value of one of these parcels dropped substantially below cost. The write-down converted the company's already meager earnings to a loss, causing a stockholder to dispose of his stock.

The following year, the company sold its other parcel of ground at a gain which exceeded earnings for the last ten years combined. What do I tell the selling stockholder when he asks such questions as:

> Did the company really make all that money in one year? If not, how come the last nine years showed so little gain and even a loss last year when the other parcel was written down to market value?

How credible did my audit make those financial statements?

Financial Statements Give Erroneous Impression of Precision

The language and dollar amounts which appear in financial statements convey a much greater degree of precision than can be justified. In many respects, the accountant acts like the head linesman in a football game. After unpiling fifteen or twenty players, the referee places the ball approximately where he feels it belongs. Then the head linesman runs in with the chains to see whether the ball is one inch short or two inches beyond the first down line. So it is with accountants. After approximating the amount of receivables which will be collected, the resulting estimate is shown as $614,319.23. Nowhere is the reader put on notice that the accountant is only 95% certain that the receivables total 10% more or less than $614,319.23. If that is the degree of the accountant's certainty, shouldn't the financial statements say so?

By stating earnings per share as an absolute amount of dollars and cents, that commonly used index is invested with a much greater degree of precision than any knowledgeable insider intends. Might not this aura of precision be laid to rest if earnings per share were stated as a range rather than as an absolute amount? The use of a range might also lessen the impression of absolute accuracy which readers now obtain from financial statements.

Need for Audit Research

Until recently, there has been virtually no research as to the effectiveness of audit procedures, reflecting auditing's general position as the accounting profession's poor relation. While vast sums have been committed to accounting research and the work of the APB, only meager resources have been committed to auditing. Except for statistical sampling, audit procedures have largely been developed by doing rather than by empirical research.

It's time to subject generally used audit procedures to critical examination. Just how effective are receivable confirmations, inventory observations, etc.? The accounting profession might well take a hard look at what went wrong when companies with robust statements, recently audited, suddenly go bankrupt. For example, if receivables turn out to be non-existent, perhaps CPAs should rethink the audit procedures which failed to uncover the problem. Perhaps research might uncover better audit procedures.

None of these comments should be interpreted as criticism of the recent revival of the Committee on Auditing Procedure. That committee's present schedule could hardly be called "too little" even though it certainly came much "too late."

Accountants' Financial Responsibility

There seems to be a growing interest in the CPA's financial resources. During a recent meeting, a banker put it quite succinctly. He asked: "You say that CPAs are unlimitedly liable for their work. What assurance does that give a financial statement user? Are CPAs bonded? Is there any place we can determine the extent of a CPA's assets or insurance?"

It is inevitable that the SEC will soon be asking similar questions. A suggestion, heard infrequently in the past, that CPAs publish their own financial statements, was recently repeated by John Burton, newly appointed Chief Accountant of the SEC. The size of an audit fee vis-a-vis the CPA's total income or resources could well bear on the question of the CPA's independence.

Shortly after World War 1, so the story goes, the King of England sought advice concerning his country's perilous financial condition. A consultant supposedly advised him to put India in his wife's name. The uncertainties of public accounting and the soaring cost of liability insurance have prompted many CPAs to take a similar route. Acceleration of this trend could serve to accentuate the public's concern over the CPA's financial responsibility.

Perhaps the public's new-found concern over the accounting profession is a sign that we have arrived. At least now we are noticed. The CPA's increased prominence brings to mind the old story of a man who, having been tarred and feathered, was being ridden out of town on a rail. When he was asked how he felt about his predicament, he replied: "If it weren't for the honor, I'd rather walk."

Reporting Requirements Burdensome to Small Business

Although most reporting requirements are equally valid for both large and small companies, a few rules are obviously geared to the needs of publicly held companies. At present, reporting requirements apply equally to companies of all sizes. Complying with certain of the reporting requirements (e.g., reporting earnings per share) can sometimes prove burdensome to a closely held company —a burden which produces meaningless data. It's time that each accounting and auditing pronouncement be scrutinized to determine whether or not it should apply equally to public and non-public companies.

Promulgating Auditing Standards—A Problem of Coordination

Inherent in many APB announcements are a number of practical auditing and reporting problems. Even though the Committee on Auditing Procedure and the APB are both arms of the AICPA, there appear to be some coordination problems. When the APB's functions are taken over by the new Financial Accounting Standards Board, a completely independent entity, the problems of coordination are likely to increase.

Here are a few examples of the hot potatoes with which the Committee on Auditing Procedure has dealt in recent months. At least in some cases, the problems have been magnified by the APB's unwillingness to expand its general pronouncements by including more specifics.

1. APB Opinion 20 prevents a change to a less preferable accounting method. This first raises the question as to what accounting method is preferable in a given situation. Furthermore, it places the auditor in a somewhat awkward posture when one client changes to a preferable method of accounting while another client, in identical circumstances, continues to use a less preferable method. The CPA must give a clean opinion to both clients so long as consistency is maintained by each. In effect, the CPA is expressing an opinion that the second client is reporting in a manner which is "consistently unpreferable."
2. APB Opinion 18 prescribes the equity method for subsidiaries in which the parent owns 50% or less where the parent exercises "significant influence." Here the APB has attempted to suggest a reasonable guideline by stating that 20% or more ownership will normally be considered "significant." Auditors may expect considerable client pressure against the equity method when a 25%-owned subsidiary loses money. On the other hand, contrary pressures may be expected when an 18%-owned subsidiary shows excellent earnings.
3. Similar problems arise when consolidating financial statements. Where the subsidiary reports on a different fiscal year than the parent, which statements of the subsidiary should be consolidated with the parent? The SEC permits consolidation with subsidiary statements prepared within 93 days of the parent's closing date. The APB, however, has not been that specific. This leaves the auditor with a serious problem. Should the parent consolidate with audited financial statements for the subsidiary (which statements could be as much as eleven months old) or should more current unaudited financial statements be used?

Comfort Letters

I had intended to report to you on an interview with an investment banker concerning comfort letters. However, his teeth were chattering so from the "cold comfort" he's been receiving from auditors' comfort letters that I couldn't understand him. Consequently, let me close with a few unusual applications of statistical sampling.

Statistical Sampling

I am told that a major life insurance company, seeking to speed up payment of death claims, decided to use a computerized statistical model to forecast when policyholders' claims would come due. In this way, the company hoped to virtually eliminate the need for filing claims. Those policyholders who received payments of "death" claims were somewhat startled and began to wonder whether the insurance company knew something they didn't know. However, few complaints were received from these policyholders. Major complaints came from widows who upon filing claims on the death of their spouses received a computer-produced form letter stating that their husbands were not "statistically dead."

A large department store, seeking to speed up its monthly billing procedure, devised a computerized model of its business. Feeding in historical data concerning the buying habits of each customer, the computer could then produce monthly bills without becoming bogged down by the need for posting each individual charge slip. Customers were merely billed an amount equal to their historical purchases for a given month. The store was finally forced to abandon the system, not because it received many complaints, but primarily because charge business tripled when details of the new system leaked out. Describing the experiment to his superiors, the innovative controller who had devised the new system said that he had good news and bad news. The good news: just as predicted by the system designer, even a tripling of charge business put no strain on the billing system. With no increase in office personnel whatsoever, the same bills were mailed monthly to charge customers as before the volume increase. The bad news: the department store was experiencing difficulty in paying its suppliers. The controller suggested that even this deficiency could be resolved if all suppliers would adopt the same billing system.

Despite the difficulties experienced by these two companies, my partners and I decided to experiment with statistical sampling in our accounting practice. Other practitioners assured us that statistical sampling prevented over-auditing and provided, at the same time, an acceptable confidence level. We reasoned that if statistical sampling can work on a client-by-client basis, why not for our entire practice? Consequently, we now audit a meticulously selected random sample of our clientele, before rendering an opinion on *all* of our clients. Naturally, we bill all clients—to avoid any charge of unethical conduct. Let me now recall, as best I can, one final dream—really just a catnap—that occurred shortly after we adopted this new modern approach to auditing.

As this dream opens, my six partners and I are standing before Judge Walter Mansfield just before sentencing. I never did hear the charge, only the jury's verdict. Oddly enough, the judge was dressed in the ceremonial robes normally worn by the Emperor of Japan and was singing an excerpt from the Mikado, one of my favorite Gilbert and Sullivan operettas. Translated into English, his song went something like this:

"My object all sublime,
I shall achieve in time,
To let the punishment fit the crime,
The punishment fit the crime."

With this brief preamble, the judge announced the sentence: the seven of us were to be arranged in random number order (using the last three digits of our respective social security numbers) before a firing squad of 21 guns. [I remember thinking what a shame that my first 21-gun salute was also to be my last.] Each gun, though equipped with six chambers, would contain but one bullet. In this way, the judge stated that he was "95% sure that 82% of us would survive—give or take 10%."

As we were remanded to the sheriff's custody, the judge said that he would have acquitted us had the case been tried before him without a jury—a statement which relieved all seven of us greatly.

In closing, I say to our chairman, the arranger of this excellent symposium, that I am delighted that he asked me to talk about problems, not solutions. And to all of you . . . pleasant dreams!