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Defining the role and responsibilities of independent auditors: a progress report to Council

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<u>DEFINING THE ROLE AND RESPONSIBILITIES OF INDEPENDENT AUDITORS</u>

<u>A PROGRESS REPORT TO COUNCIL</u>

MANUEL F. COHEN, CHAIRMAN

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A PROGRESS REPORT TO COUNCIL

We are here to report on the progress of the work of the Commission on Auditors' Responsibilities, to discuss some of the problems we have encountered, to expose our thinking on some critical issues, and to seek feedback that will help us in our work. It is now almost eighteen months since we undertook our study. I am sure that you are concerned, as the Commission is, that we complete our work as expeditiously as possible. However, we are in the middle of an enormous and complex assignment. We have spent about forty-two days in meetings of the full Commission and many more hours in preparation. Our goal is to define the role and responsibilities of independent auditors and to recommend carefully developed standards by which their performance should be evaluated.

I must remind you at the outset that we are not a standard-setting body. Our conclusions and recommendations will not be issued as authoritative pronouncements. Their authority will rest on their persuasiveness. An integral part of our work is to persuade other bodies to adopt and implement our recommendations.

Despite the absence of visible signs, we have made significant progress in our study. The forty-page Statement of Issues, which we published last fall, indicates the scope of our study. Briefly summarize, the total project consists of three fundamental elements. The first is a group of studies intended to develop an appropriate and workable concept of responsibility in a number of critical areas, such as uncertainty, fraud, illegal acts of management and communication of the results of the examination including the formation of an opinion on financial statements—the "present fairly" issue.

A second element involves consideration of the current role of the auditor as it may be affected by other services, such as MAS and tax, and how that role might be affected by extension to new areas, such as forecasts. Despite the withdrawal of its proposal by the SEC, various pressures to engage in forecasting will continue.

However, no statement of auditors' responsibilities will be useful unless it is within the capacity of the auditor and it is consistent with the reasonable expectations of users. Therefore, the third element of our study is a comparison of the "resource inventory" of the auditor—

e.g., his education, useful auditing standards and procedures, the professional climate and regulatory structure within which he works—with a reasonable conception of his responsibilities.

In addressing those issues, we have been probing such fundamental questions as:

- What function do independent auditors perform when they express opinions on financial statements?
- How closely is the auditor's function tied to the financial information with which he is associated? For example, does an annual audit involve a responsibility limited to the financial statements or is there some continuous responsibility not limited to particular financial statements?
- To what extent does the auditor have a whistle-blowing obligation?
- Should the auditing profession be viewed as a single, unitary one or a tiered profession with two or more layers that involve different types of practice?

Another fundamental question relates to the procedural direction we are following. Are we devoting too much time to issues under study by the Institute's auditing standards executive committee or the Securities and Exchange Commission? We think not. Our perspective is different from that of the auditing standards committee or the SEC. We are considering all of the issues in a broad integrated framework. Our objective is to articulate a coherent, consistent, and <u>useful</u> position on the sensitive issues that shape the concept and understanding of the role and responsibilities of independent auditors.

Let me review where we stand today on some of those issues. I emphasize that these "stands" are tentative positions that will continue to evolve as we receive more evidence from our own research and more feedback from individuals and groups such as this. I urge you to use the simultaneous sessions that follow to comment on the specific points I will make in the next few minutes.

We recognize that our conclusions on each issue must be consistent with a realistic conception of the independent auditor's role in society. Basic to our study is the conclusion that the essential role of the independent auditor and the need for the function he performs lie in the contribution he can make to the credibility of the financial information so essential to the public's overall confidence in financial markets. Consequently, we believe that a broader examination of the auditor's role with respect to financial information beyond formal financial statements is necessary for a reasonable evaluation of demands for and possible extensions of the auditor's traditional role.

On a more specific level, we are attempting to resolve the persistent confusion that has surrounded the use of the term "present fairly." The result of that work—at least to date—is in the paper "Forming an Opinion on Financial Presentations," that was distributed to you before this meeting. This paper, tentative though it is, "fairly presents" the direction of the thinking of the Commission at this point, the level at which we are examining the issues, and the type of conclusions being developed.

Widespread misunderstanding of the term "present fairly" has contributed to the expectation gap confronting auditors. Judge MacMahon's observation in the Herzfeld case that the courts are appropriately concerned with "whether the report fairly presents the true financial position...to the untutored eye of an ordinary investor," is evidence of the confusion. In addressing the issue, we have not continued the debate about what "present fairly" means to all who read that phrase. Instead, we have attempted to state more precisely the nature of the judgments and decisions required in forming an opinion on financial statements. A better understanding of the role of judgment in the application of generally accepted accounting principles and a strengthening of generally accepted auditing standards to provide independent auditors with improved guides to apply judgment should minimize if not eliminate much of the debate and confusion. We would impose greater and more explicit responsibility on the auditor for judging the appropriateness of the accounting principles selected and provide him with more explicit guidance for making that evaluation. We would require auditors to stand back and evaluate the appropriateness of the overall effect of the accounting principles selected and the overall effect of the individual decisions made.

We believe it necessary to strengthen the message that the financial statements are the representations of management. Thus, we have tentatively concluded that, when a company faces unusual uncertainties, the financial statements and related disclosures should bear the burden of highlighting those uncertainties and that the "subject to" opinion should be eliminated. A strategically placed note to the financial statements describing the uncertainty and disclosing the possible material adverse effect of an unfavorable outcome would be far more desirable than the often misunderstood and usually redundant "subject to" opinion. This is consistent with our view that management should assume a greater affirmative obligation of analysis and interpretation of the financial statements and related disclosures.

In another area, we are attempting to clarify the auditor's responsibility for the detection of management fraud. In an audit of financial statements, an independent auditor is concerned with the adequacy of controls and other measures designed to prevent fraud. Auditing standards should clearly state that he has an affirmative duty to look for fraud. However he should not always be held liable for failure to find it. Instead, his performance ought to be evaluated on the basis of the extent to which he exercises professional skill and care commensurate with a reasonable estimate of the costs and benefits of the audit function. The exercise of professional skill and care is the touchstone. The elements that constitute the exercise of professional skill and care ought to be identified and adopted as a part of auditing standards. We are attempting to identify the substance of those elements.

We have wrestled with two issues without yet developing a consensus. The first concerns the auditor's responsibility for the detection and disclosure of illegal and improper acts of management. That issue is perhaps the hottest topic around today if not necessarily the most important in the long run. In January, Senator William Proxmire, Chairman of the Joint Congressional Subcommittee on Priorities and Economy in Government, in an exchange with SEC Chairman Roderick Hills, seemed to imply that the auditor should have the responsibility not only for disclosing such payments but also of uncovering them. Of course, we recognize that the independent auditor's responsibility for illegal payments that have a material effect on the financial statements is the same as his responsibility for the detection of management fraud. His performance should be governed by the standard of professional skill and care appropriate to fraud. Beyond that, the issue becomes very murky. One thing seems clear to us: The responsibility for disclosing known illegal or improper acts is different, and should be considered separately from responsibility the independent auditor may have for detecting such behavior.

I have been closely involved as legal counsel in several of the leading cases in this area. I know how delicate and sensitive the question of the independent auditor's responsibility is. There are few guidelines. Confusing signals appear to emanate from the Securities and Exchange Commission. Some guidelines have been promised by the SEC. However, until useful guidelines are developed, the best that we can hope to do is to lay out some possible alternatives for defining the auditor's responsibility consistent with our conception of his role. At this stage, we have no clear-cut solution. The questions are perplexing. What role should materiality play? How should it be defined? To whom should a disclosure responsibility run? What would be the impact on the auditor-client relationship?

The stakes are high. We cannot simply wait for the regulatory bodies to set guidelines. We must speak forcefully to this issue and help to shape the evolving role of the independent auditor in this area from a perspective broader than merely the currently fashionable concern for illegal campaign contributions and foreign bribes.

The second issue, with which we are still struggling, concerns the communication actually provided in auditor's reports. Evidence abounds that the standard report is misunderstood. Recent surveys indicate that many investors do not bother to read the auditor's report and that those who do read it do not understand the premises on which it is based and the nature and limitations of the conclusions intended to be conveyed. More disturbing is the evidence from these surveys and other sources that many investors view the report as a "Good Housekeeping Seal of Approval."

We have concluded that ways must be found to communicate better to those who rely on the work of independent auditors. We are considering alternative ways of doing this that are not limited to small revisions in the language in the auditor's report. We have reached a consensus to recommend that a report by the chief financial officer be included with the auditor's report to reinforce the message that the financial statements are the representations of management and to explain more precisely the role of the independent auditor in their presentation. Moreover, we are looking at the issue of communication not merely in terms of the traditional standard report but also in terms of other possible reports on other financial information. We plan to expose our views on possible alternatives and to elicit comment and criticism at public hearings.

I cannot emphasize too strongly that we are not compartmentalizing issues. Our conclusions on each issue must be tested against our conclusions on other issues.

We have a broad range of interrelated issues and are conducting research to develop evidence that will be useful in our deliberations on those issues. Indeed, our research effort is the core of our study.

Three of our research projects are designed to help us identify problem areas in practice and to determine what can be done. The first is a broad survey and analysis of legal and other cases involving alleged audit failures. This is basic to the entire project and involves a large manpower commitment. The staff is compiling a data bank of significant cases in the last ten years.

The second project is a questionnaire survey of current and former staff auditors. The sample was selected from the membership of the Institute. The survey is designed to study the effects of selected aspects of auditors' work environment, such as time-budget pressures, on their behavior and performance.

The third project in this category consists of interviews of technical partners and legal counsel of audit firms by members of the Commission and senior members of the Commission's staff. The interviews are arranged to allow those on the firing line to discuss with us in confidence some of the problems they have encountered in their experience.

In other areas, we are involved with two questionnaire surveys. The first queries analysts and investors on the significance to them of disclosures in financial statements concerning illegal and other improper acts of management.

It focuses on acts whose effects are not material in traditional financial statement terms. The purpose is to determine whether analysts and investors consider such information significant for their investment decisions.

The second survey, conducted by researchers at the University of Illinois, concerns communication in the auditor's standard report. We hope to obtain from the study more information on users' understanding of the auditor's standard report in its present form.

In another area, we are sponsoring a symposium on the implications of the growing body of literature and empirical evidence that seem to suggest that the present scheme of financial reporting has very little impact on the functioning of capital markets. Several leading authorities have been invited to discuss the problem for our benefit.

We are ever mindful of the need to consider the incremental costs and benefits of any changes that we may recommend. For that reason, we have commissioned a study to develop a conceptual model for analyzing the cost-benefit relationships of the audit function.

In addition, our staff and consultants have prepared background papers on all of the issues on which we are reaching tentative conclusions. Additional papers are in preparation. They include papers on:

1. New forms of reporting.
2. Regulation of the auditing profession.
3. Education and training of auditors.
4. The relationship between the auditor and parties interested in the audit function.
5. The auditor's legal environment.

It would serve no purpose here to repeat the issues in our Statement of Issues. You are aware that they run the gamut of problems significant to independent auditors. We are considering the whole broad structure by which independent auditors are trained, regulated, and disciplined. We are looking at the structure of the profession from the broadest possible perspective. We are not ignoring the problems of any segment of the profession. In probing the question whether more explicit recognition should be given to the multi-tiered character of the profession, we are giving special attention to the problems of sole practitioners and firms with several rather than hundreds of partners.

As might be expected with a project of this complexity, there has been a considerable start-up period. Lee Seidler, now serving as deputy chairman of the Commission, has assumed principal responsibility for day-to-day policy implementation of Commission activities. Doug Carmichael, who recently became the managing director of the technical divisions of the Institute, devotes substantial time to directing the Commission's staff.

Each member of the Commission works closely with assigned staff on specific projects.

As we completed the clarification of the issues facing the Commission, it became clear that the amount of skilled, experienced person power resources necessary for the effective completion of our task would be far greater than was originally contemplated.

Three months ago, we began to seek the needed additional assistance. The critical need is for experienced audit personnel who can apply that experience to the work of the Commission. We asked the major accounting firms to provide such personnel to the Commission, by lending us several managers for an extended period.

Unfortunately, we have not been successful in obtaining the necessary manpower. Two firms, Arthur Young and Coopers & Lybrand, responded quickly and effectively. A highly competent person from each firm is now working full time with the Commission. One of them, Bob Temkin of Arthur Young, will be at one of the simultaneous sessions. Another firm, Peat, Marwick, has identified a staff member who will start with the Commission shortly. Haskins & Sells is not only supplying Ken Stringer as a member of the Commission, but has identified two managers who will join our staff.

But, our needs are far greater. I regret to say that no other firms have yet found themselves able to identify and provide the resources we require. I cannot exaggerate the seriousness of the problem and its potential impact on our ultimate possibility of success or failure.

The Commission has been operating for 18 months and has achieved, as I have noted, a good deal of success if only in educating its chairman. A great deal of work remains.

After a careful review of all the remaining issues and projects, and some paring of the scope of our work, we estimate that an absolute minimum of 700 man weeks will be needed to complete our task. At our current staff level, reflecting all the new assistance I have just mentioned, at most, less than 400 man weeks are available to us. Simple arithmetic suggests that almost two years of work remain.

Two more years is an unacceptable period.

First, and most important, our report is needed by the profession, and in less than two years from now.

Although we are constantly attempting to view our work in a long-term perspective, if the Commission's total life were to run to almost four years, we would undoubtedly find that the rapid pace of change would condemn us to update continually much of our earlier work.... suggesting a never ending task. Even today, the intensified activities of AudSEC, which we applaud, force us to update constantly those portions of our report that purport to describe the "current" state of the art.

Third, three of the staff members made available to us by the firms will be on loan for only one year, and it would be unfair, in terms of their own careers, to expect them to leave their regular work for a longer period.

Lastly, some consideration must be given to the Commission members. Their initial agreement to serve on the Commission was predicated on estimates that the task would require no more than a year and half. We have already exceeded that figure.

Every member of the Commission continues to hold his regular position of major responsibility, in addition to his work on the Commission. Every member has made a considerable personal sacrifice to serve on the Commission, and every member is willing to continue to do so.... for a reasonable period of time. However, it is unfair for the accounting profession to expect a time commitment of more than three times that which was originally contemplated.... and it is even more unfair to expect such a commitment in the absence of a vitally necessary contribution from the profession.

If we are to finish our task, not many years from now, but within the maximum feasible time period of one more year, we need at least 300 man weeks—6 experienced, competent staff members—drawn from the ranks of the profession.

In a profession of well over 100 thousand members, where some firms have more than 10 thousand professional staff, where some annual audits require the equivalent of more than 50 man years, I cannot believe that our requirements are unreasonable.

If the work of the Commission is truly important to the profession, if the sacrifices of the Commission members are to be justified, the profession must stand up and be counted by providing the assistance we so vitally need.

Where do we go from here? As I have tried to indicate, we have made a great deal of progress so far. Further progress is largely up to you, the leaders of the American accounting profession.

Assuming that we do receive the assistance we require, we will continue our progress towards conclusions on many of the issues. We expect to publish soon the first of a series of discussion documents and schedule public hearings. After the public hearings have been conducted and all of the evidence is in, we will proceed to complete our deliberations and prepare our final report.

From you, we ask interest, cooperation, evaluation and frank criticism. There will be a member of the Commission and its staff in each of the concurrent sessions. You have had a chance to read one of our tentative papers and to hear our report. Now, I urge you to speak to us critically and constructively in the concurrent sessions that follow.

Manuel F. Cohen, Chairman
Commission on Auditors' Responsibilities
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