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Commission on Auditors' Responsibilities: Report of Tentative Conclusions

Commission on Auditors' Responsibilities

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The Commission on Auditors' Responsibilities:

Report of Tentative Conclusions

THE COMMISSION ON AUDITORS' RESPONSIBILITIES

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The Commission on Auditors' Responsibilities:

Report of Tentative Conclusions

An Independent Commission
Established by the
American Institute of Certified
Public Accountants

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The Commission on Auditors' Responsibilities
1211 Avenue of the Americas, New York, N.Y. 10036

Preface

The Commission on Auditors' Responsibilities was established in October 1974 to study the role and responsibilities of independent auditors. This report presents our tentative conclusions and recommendations. We are issuing this report to expose our conclusions to a wide audience and to obtain analysis, evaluation, and criticism from all interested parties before completing our work and issuing the final report.

The tentative conclusions and recommendations are based on research, consultation, analysis, and deliberation. Although we have not previously issued a general call for assistance, we did publish and distribute widely a *Statement of Issues* in the fall of 1975 that indicated our desire to give early consideration to relevant research.

We believe that we have considered all available evidence and that our conclusions and recommendations are supported by evidence and reasoning and are internally consistent. We urge all interested parties to consider not only our conclusions and recommendations but also the supporting evidence and reasoning. We solicit and will fully consider all well-supported suggestions for change. Suggestions may be presented orally or in writing.

To afford interested parties an opportunity to make oral presentations, we will hold a public meeting to begin at 9:30 AM on Tuesday, June 21, 1977, in the Senate Room at the Capitol Hilton hotel at 16th and K Streets, Washington, D.C. It will continue as long as necessary to accommodate all those who request time to be heard.

Those who desire to make oral presentations at the public meeting should inform the Commission on or before May 16, 1977, and identify the individuals who will make the presentation, the organization they represent (if any), the amount of time desired, and, if feasible, the matters that will be discussed. Oral presentations will be more effective if a written summary is submitted sufficiently in advance for study by the Commission.

Those who desire to make written presentations should send them to the Commission at the address below. Written presentations should reach the Commission on or before June 13, 1977.

Written comments and requests to appear at the public meeting should be addressed to

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Introduction

The Commission on Auditors' Responsibilities was charged to

> develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors. It should consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish. If such a gap does exist, it needs to be explored to determine how the disparity can be resolved.

The Commission has met monthly since November 1974, for a total of 58 meeting days, conducted a series of research projects, met and consulted with a variety of interested parties, and considered a range of issues concerning the independent audit function.

This report describes the research and presents the analysis, conclusions, and recommendations of the Commission. It is formally presented to the Board of Directors of the American Institute of Certified Public Accountants, the body which appointed the Commission and which provided its principal financial support. However, the members of the Commission interpreted their charge to be a mandate to study all aspects of the independent audit function and to provide recommendations to, and for the benefit of, all groups interested in the function, including users of financial statements, management, auditors, and regulatory bodies.

Some of the recommendations in this report can be adopted by the AICPA. Some will require action by other official bodies, such as the Financial Accounting Standards Board and the Securities and Exchange Commission. However, we believe that many of the recommendations can be implemented through voluntary action principally by independent auditors and corporate managements and directors acting together to improve the financial reporting environment.

A GAP BETWEEN PERFORMANCE AND EXPECTATIONS

The portion of the Commission's charge quoted above suggests the possibility that a gap exists between the performance of auditors and the expectations of the users of financial statements. The primary emphasis of this project has been to examine that possibility. After considerable study of available evidence and its own research, the Commission concludes that such a gap does exist. However, principal responsibility does not appear to lie with the users of financial statements.

In general, users appear to have reasonable expectations of the abilities of auditors and of the assurances they can give. The only exceptions consist of the exaggeration of the auditor's responsibilities sometimes found in the allegations of those who have brought legal actions against auditors and in the expectations of some users in the area of proposed expansion of the auditor's responsibilities to new forms of information.

Although users' expectations are generally reasonable, many users appear to misunderstand the role of the auditor and the nature of the service he offers. The Commission has therefore recommended a number of changes designed to improve communication of the auditor's work and of the respective roles of management and the auditor.

The burden of narrowing the gap between performance and expectations falls primarily on auditors and other parties involved in the preparation and presentation of financial information. Sections 2, 3, 4, 5, and 7 of this report contain suggestions for immediate changes that would reduce the gap. Many other recommendations with a similar purpose will be found throughout the report.

To the extent that a gap exists between performance and expectations, it is traceable more to long-range forces than to specific performance deficiencies of auditors or the profession. The public accounting profession has failed to react and evolve rapidly enough to keep pace with the speed of change in the American business environment. That failure in the development of accounting principles was noted by the Study Group on the Establishment of Accounting Principles (the Wheat study group), whose report led to the formation of the Financial Accounting Standards Board. We believe that this Commission's report demonstrates a similar failure of the development of the audit function. Therefore, many of the recommendations in this report are designed to speed the pace of change in the profession and to make it more receptive to the forces of change in the future.

GENERAL NATURE OF RECOMMENDATIONS

The Commission has considered the costs and benefits associated with its recommendations and the difficulties their adoption might involve. The Commission has deliberately avoided making its recommendations too specific. We believe that precise details of implementation and operation are best left to those responsible for making the changes.

THE DISTINCTION BETWEEN ACCOUNTING AND AUDITING

This Commission is concerned with issues related to auditing. In the course of its work, the Commission noted frequent confusion between auditing and accounting and a misunderstanding of the scope of the Commission's work.

In the broadest sense, the discipline of accounting includes auditing. However, accounting can be described as measuring and reporting the effects of economic activities of individual entities. Auditing, on the other hand, involves an independent examination to determine the propriety of accounting processes, measurements, and communication. Stated simply, the accountant prepares financial information; the auditor checks it.

This distinction, however, cannot be made in practice. To perform his function, the auditor must continually evaluate accounting activities and presentations; he must be, and is, trained as an accountant *and* an auditor. This joint nature extends to the profession as a whole. The term "accounting profession" is generally considered to embrace public accountants—those who offer their services to a variety of clients rather than to one employer. The primary function of public accountants is auditing. The largest organization of public accountants in the United States is the American Institute of Certified Public Accountants, whose principal activities are now concerned with auditing and auditors.

Thus, some confusion on the part of outside observers is understandable. This Commission is concerned with matters related to the audit function and to accountants acting in the capacity of auditors. Its charge and its activities are *not* concerned with the establishment or promulgation of principles of accounting and financial reporting, nor of related disclosure requirements. Nevertheless, the decision processes involved in the selection and application of accounting principles and the evaluation of disclosure are a major element of auditing and received full consideration by the Commission.

COMMISSION ORIENTATION TOWARD AUDITING OF PUBLICLY HELD COMPANIES

This report is principally, although not exclusively, devoted to issues related to audits of entities whose securities are publicly traded and whose financial statements are disseminated to large numbers of users. This orientation is not an accident nor did it occur by default.

The members of the Commission understand that much of the practice of many certified public accountants involves audits of privately held entities and accounting and related services other than independent audits. There are significant unresolved issues and problems associated with such practice.

At the outset, the Commission intended to deal with the full range of problems facing auditors, including those peculiar to smaller practice units and smaller clients. However, assessment of the scope of the Commission's charge showed that its work required some limitation. It appeared to the members of the Commission that most of the current difficulties in the relationship between the public accounting profession and the rest of society were traceable to issues principally related to the audits of corporations whose securities are publicly traded. The Commission believed that its resources could best be devoted to more intensive study of those issues.

However, issues principally associated with smaller practice units have not been ignored. Attention has been devoted to the problems related to smaller practice units in a number of parts of this report, including the recommendation that the proposed Auditing Standards Board be organized to provide separate consideration of those problems.

ORIENTATION OF THE COMMISSION'S REPORT TOWARD THE FUTURE

In researching and developing its conclusions on the various issues it studied, the Commission had to examine and comment on aspects of past, present, and future auditing. The Commission's charge and its entire orientation, however, are directed toward improvements in the *future* auditing environment. The Commission has not attempted to provide a definitive assessment of the performance of auditors, individually or collectively, in relation to past or current standards of the profession. Nor has the Commission tried to provide a definitive statement of the responsibilities of auditors for any period before the date of its report of tentative conclusions, the date of its final report, or the adoption of changes suggested by its final report.

Therefore, it is completely inappropriate to cite this report in any respect as an authoritative indication of appropriate auditing standards or auditor performance for any period before adoption of its recommendations.

MEMBERS OF THE COMMISSION

The members of the Commission were chosen to provide contributions from a wide variety of backgrounds and experience. The chairman of the Commission, Manuel F. Cohen, is a partner in the law firm of Wilmer, Cutler & Pickering and a former chairman of the Securities and Exchange Commission. The deputy chairman, Lee J. Seidler, is professor of accounting at New York University and a consulting financial analyst. Walter S. Holmes, Jr., is chairman of the board and chief executive officer of C.I.T. Financial Corporation. William C. Norby is senior vice-president of Duff & Phelps, Inc., an independent investment research firm, and is a former president of the Financial Analysts Federation. LeRoy Layton, who recently retired as the managing partner of the public accounting firm of Main Lafrentz & Co., is a former president of the AICPA and a former chairman of the Accounting Principles Board. Kenneth W. Stringer is the senior technical partner of the public accounting firm of Haskins & Sells. John J. van Benten is the managing partner of the public accounting firm of George S. Olive & Co.

The affiliations of Commission members, and those of staff members indicated below, are provided only for identification. The members of the Commission and its staff were not selected to represent particular constituencies, firms, or organizations, nor did they view themselves in that way or act in such a manner.

THE COMMISSION'S STAFF

To cope with the wide-ranging subject matter of this study, the Commission's staff is drawn from a number of sources and has a variety of skills and experience. The deputy chairman, Lee J. Seidler, has been in charge of day-to-day operation of the Commission and staff. Douglas R. Carmichael, managing director, Technical Services, of the AICPA and a former professor of accounting at the University of Texas, is the Commission's research director and, with Professor Seidler, is the principal writer and editor of the report. Robert H. Temkin, a partner of the public accounting firm of Arthur Young & Co., serves as staff director. Professor Henry R. Jaenicke, chairman of the department of business administration at Franklin and Marshall College, is the principal research consultant to the Commission.

Paul Rosenfield, director of the AICPA's Technical Research Division, provides research, writing, and editorial support. Thomas W. McRae and Brian Zell, also of the Institute's Technical Research Division, give research and editorial assistance.

The Commission's analysis of significant cases against auditors and other research related to auditing practice required staff with extensive, current auditing experience. The analysis was performed by members of the staffs of public accounting firms on assignment to the Commission, principally Alan N. Certain, a manager in Price Waterhouse & Co., Eugene F. De Mark, a manager with Peat, Marwick, Mitchell & Co., and Ann Gabriel, a supervisor with Coopers & Lybrand. Wenona Waldo of Alexander Grant & Co. and Jerald Folk of Haskins & Sells also assisted.

The Commission's survey of accounting firm partners and staff members was conducted by Professor John Grant Rhode of the University of California. Professor Jeremy Wiesen of N.Y.U. prepared the Commission's study on congressional and legislative intent and provided continuing legal research assistance to the staff. Marilyn Brown, CFA, prepared the Commission's paper on user needs for reports on internal control and provided other consulting and research assistance. Professor Melvin Shakun of New York University prepared the Commission's paper on benefit-cost analysis. Other research work for the Commission was performed by Professor Lewis Davidson of the University of North Carolina, Professor Richard Ziegler of the University of Illinois, and Robert K. Mautz, a partner with Ernst & Ernst. Professor Barbara Merino of New York University reviewed the Commission's report for historical matters. Patricia McConnell, a CPA and a doctoral candidate at New York University, serves as Professor Seidler's research assistant.

Supporting staff of the AICPA were of great assistance, and the Commission owes a particular debt to Christine Seifert and Juliette-Rose Garvey for preparation of the manuscript.

THE INDEPENDENCE OF THE COMMISSION

The Board of Directors of the American Institute of Certified Public Accountants established the Commission as "an independent study group." While the term *independent* was never defined for the Commission, we have taken the word to mean that the members of the Commission and its staff would have full freedom and responsibility to determine the scope of its study, the issues to be examined and the manner in which they would be examined; that the members of the Commission and its staff would be free of outside influences and restrictions and would not be considered to represent particular constituencies; that the Commission would be provided with adequate resources; and that the Commission's report would be widely disseminated, regardless of its conclusions. All of those conditions have been met, and the Commission believes that its work and conclusions are independent. The final determination of that independence, of course, will be made by the readers of this report.

While the independence of this Commission depends more on the attitudes of the members and the staff than on specific arrangements, the arrangements may be of interest. No member of the Commission received compensation from the AICPA; all the members continued to receive normal compensation from their regular employers or firms. The level of involvement of the deputy chairman was such that he was required to be released from teaching responsibilities during most of the Commission's operations. In this period, the AICPA reimbursed New York University for the compensation it continued to pay him.

Some members of the staff of the Commission are regular employees of the AICPA. Members of the staff who are associated with public accounting firms continued to receive their normal compensation from those firms. Their services were contributed by the firms. Other members of the staff, principally academics who conducted research projects for the Commission, were compensated by the AICPA on a consulting basis as determined by the Commission.

The AICPA provided the Commission and staff with meeting facilities, travel expenses, office and related support services, printing, and mailing. The Commission's requirements in those respects were fully satisfied with no restrictions or conditions.

During its two and a half years of operation, the Commission made two interim progress reports to the Council of the AICPA and one to the Board of Directors of the AICPA. Other than those reports, no formal or informal contacts were maintained between the Commission and the AICPA besides those related to resource arrangements.

STATUS OF CONCLUSIONS

The conclusions and recommendations in this Report of Tentative Conclusions have been agreed to by the members of the Commission on Auditors' Responsibilities. However, consideration and discussion of this Report of Tentative Conclusions may result in changes in the conclusions and recommendations and in the views of individual members.

Summary of Conclusions and Recommendations

This brief summary of the conclusions and recommendations of the Commission on Auditors' Responsibilities has been prepared for the convenience of readers of the report. It does not include the supporting evidence and rationale.

The Commission was charged with studying the auditor's role and responsibilities and the related needs and expectations of users of financial information. The Commission believes that users' views of the auditor's responsibilities are realistic and that their expectations and demands are reasonable. The burden of narrowing the gap between auditor performance and user expectations falls primarily on the auditors and the other parties involved in the preparation and presentation of financial information. However, users form their expectations for auditors' services without regard to cost. In looking to auditors for expanded services, they often tend to ignore the limitations on auditors' abilities when measurements or standards have not yet been established or when information cannot be audited.

The Commission found common misunderstanding about the respective responsibilities of management and of the auditor in relation to financial information. Many users are not aware, for example, that the financial statements are developed by, and are the representations of, management.

The public and many users believe, correctly, that the auditor should safeguard their interests and help protect them against biases, errors, and misrepresentations, including material frauds and illegal or questionable acts. Many believe, incorrectly, that the auditor develops the amounts in financial statements or that he is responsible for presenting them. The Commission recommends changes in communicating the results of the audit that should clarify the distinction between management's and the auditor's roles.

The Commission studied the independent auditor's role in society, the decisions an auditor must make when he forms an opinion on financial information, reporting on uncertainties, the auditor's responsibility for detecting fraud, the auditor's role in corporate accountability, the boundaries of the auditor's role and its extension, the effectiveness of the auditor's communication with users and the public, the effectiveness of the education, training, and development of auditors, the problem of the auditor's independence, the process of establishing auditing standards, and the effectiveness of the profession's self-regulation and regulation from outside the profession. The Commission makes forty recommendations addressed to the profession and its institutions, the FASB, the SEC, state agencies, the corporate community, and the courts.

THE INDEPENDENT AUDITOR'S ROLE IN SOCIETY (Section 1)

The auditor is a third-party intermediary in an accountability relationship between the issuer of audited financial information and users of that information. His primary responsibility is to the users of his work. While the auditor is not an adversary of management, he must be independent. An active board of directors with a significant proportion of independent, outside directors to whom the auditor reports is necessary to help sustain his independence.

The potential conflict of interest between an entity's management and users of its financial information makes audits necessary. Audits are designed to assure the integrity of the financial information prepared by management and help to safeguard the assets entrusted by shareholders and creditors. Thus, audits both affect financial information and improve the entity's accountability.

FORMING AN OPINION ON FINANCIAL PRESENTATIONS (Section 2)

To evaluate management's presentation of financial information, the auditor must consider all of management's decisions in selecting and applying accounting principles and judge their appropriateness in the circumstances. The Commission believes that generally accepted accounting principles are broad enough to describe the qualities financial information should possess. The auditor must evaluate the choices made by management among alternative principles, the appropriateness of the principles applied in the absence of formal or detailed accounting pronouncements, and the cumulative effect of the decisions on selection and application of accounting principles.

The Commission considered the difficulties arising from the different meanings attributed to the phrase "present fairly in conformity with generally accepted accounting principles." We conclude that continued emphasis on "fairness" as a standard is not fruitful—the word "fairly" should be eliminated from the auditor's report. No one would argue that financial statements should not be fair, but the auditor's responsibilities are better clarified by emphasizing the judgments and decisions that must be made about the selection and application of accounting principles.

REPORTING ON SIGNIFICANT UNCERTAINTIES (Section 3)

Users do not sufficiently recognize the degree of uncertainty that affects all financial statements, and present reporting does not adequately emphasize uncertainty. A separate note in financial statements should be required on uncertainties similar to that required on accounting policies. The note should explain the significance of the uncertainties for earnings and financial position.

The note would identify material uncertainties for users, which is the purpose of the auditor's "subject to" qualification, and the requirements for the "subject to" qualification should be eliminated. The note should describe all material uncertainties, not only those that might have resulted in a qualification.

The most significant uncertainty that can cause a "subject to" qualification under present reporting requirements is doubt about a company's ability to continue to operate as a going concern, but there is no reason to believe that independent auditors are better able to predict continued business success or failure than they are able to predict the outcome of other uncertainties. The auditor's responsibility for "going concern" and other uncertainties should be to evaluate whether the disclosure presented by management includes all the available material information on the potential effect of the uncertainties on the entity's earnings and financial position.

CLARIFYING RESPONSIBILITY FOR THE DETECTION OF FRAUD (Section 4)

An audit should be designed to provide reasonable assurance that the financial statements are not affected by material fraud. The auditor should search for material fraud. The auditor should also see that financial statements report and explain the nature and effects of material frauds that are discovered.

To help evaluate whether the auditor has met those responsibilities, the Commission recommends a concept of "due professional care" as a guide for judging audit performance and to explain the elements of skill and care the auditor should exercise to meet his responsibilities. Due professional care should include requirements to establish effective client investigation programs, immediately pursue any evidence that suggests that management may be untrustworthy and to resign if the evidence cannot be refuted, observe conditions suggesting predispositions to management fraud, maintain an understanding of a client's business and industry, and be concerned with controls related to fraud prevention and detection. The profession should develop and disseminate information on

frauds and methods of detecting them. Individual auditors should be more aware of the limitations of certain audit techniques, such as confirmations.

A standard of due professional care is necessary to evaluate the auditor's performance because he cannot reasonably be expected to detect all frauds. Auditors are not criminal investigators, and a clever and dishonest management in control of the corporate records will often be able to mislead the auditor. However, the auditor should approach his work with an attitude of professional skepticism and be constantly aware that evidence obtained during the audit may require him to question management's honesty.

CORPORATE ACCOUNTABILITY AND THE LAW (Section 5)

The independent auditor should search for illegal or questionable acts and should be expected to detect those acts that the exercise of professional skill and care would normally uncover. The Commission believes, however, that management should bear the primary responsibility for meeting society's demands for corporate accountability. Management should adopt and publicize detailed policy statements indicating the conduct that will not be tolerated and develop appropriate compliance procedures.

The independent auditor could then be involved in monitoring compliance with the policies, and his report could include his conclusion on compliance. Detected illegal or questionable acts should be considered by the auditor without regard to traditional standards of materiality.

Principal responsibility for assurance on information on legal claims and litigation against clients should lie with management acting in consultation with their lawyers.

THE BOUNDARIES OF THE AUDITOR'S ROLE AND ITS EXTENSION (Section 6)

The audit function can and should expand from being oriented to periodic financial statements to include information of an accounting and financial nature that management has a responsibility to report, provided that it is produced by the accounting system and the auditor is competent to verify the information.

The audit function should include greater involvement in a company's financial reporting process on a more current and continuing basis. This expansion should begin now with a more comprehensive study and evaluation of the controls over the accounting system. The auditor's report on the audit function, issued annually, should include an evaluation of management's description of controls over the accounting system and should disclose material uncorrected deficiencies in the system of internal control not disclosed by management.

The audit should be considered as a function to be performed during a period of time rather than an audit of a particular set of financial statements. The audit function should gradually expand to include all important elements of an entity's financial reporting process. The next step should be a review of the process used by the company to prepare quarterly financial information. The auditor should give timely assurance on his review in an interim report on the audit function.

THE AUDITOR'S COMMUNICATION WITH USERS (Section 7)

The auditor's standard report, his primary means of communicating with users, is deficient in several respects and should be revised. It is now merely a complex symbol that users no longer read and is interpreted by different users in different ways. Many users view the auditor's report as a seal of approval, and some believe it means not only that the financial statements have been audited, but also that the entity is financially sound.

The Commission recommends and illustrates a new, expanded, flexible report which

should consist of a series of paragraphs with standard wording or alternatives, each describing a major element of the audit function. Corporate management should present a report that acknowledges their responsibility for the representations in the financial statements, that states the information is presented in conformity with generally accepted accounting principles appropriate in the circumstances, and that states that legal counsel has communicated the company's position with respect to litigation, claims, and assessments to the independent auditor and is satisfied that it is properly disclosed in the financial statements. The report should also present management's assessment of the company's accounting system and controls over it and describe the response of the company to material weaknesses in controls identified by the independent auditor.

The reference to consistency in the auditor's report should be deleted and responsibility for disclosure of changes reserved to management. The method of referring to the work of other auditors should be revised. The auditor's reporting requirement for unaudited information (associated with audited information) should be clarified and expanded.

To improve user access to them, auditors should be required to be present and available to answer questions at the annual meeting of shareholders.

THE EDUCATION, TRAINING, AND DEVELOPMENT OF AUDITORS (Section 8)

The formal education of prospective auditors does not adequately prepare them to meet the demands and risks of professional practice nor does it instill a needed sense of professional identity. Public accounting firms have had to assume a disproportionate burden of entry-level training of new professional accountants. An educational program similar to that of the legal profession should be gradually instituted, which would include a four-year undergraduate and a three-year graduate program in a professional school of accounting.

The AICPA and state societies should make it possible for the increasing proportion of accounting educators who are not CPAs to join those organizations and take part in their professional activities.

MAINTAINING THE INDEPENDENCE OF AUDITORS (Section 9)

Independence is considered by the public, users, and the profession to be the essential qualification of the auditor. The Commission has devoted considerable attention to the problem of maintaining independence in the private economy of the United States. Since the independent auditor is selected and paid by someone affected by his work, total independence is impossible. The Commission therefore focused attention on measures to assure that auditors maintain the necessary degree of independence.

The Commission considered the present structure of a private profession, regulated by a combination of private and governmental efforts including the courts and the SEC, and the possibility of alternate relationships such as government selection or payment of auditors. We conclude that the possible alternatives do not promise significant benefits over the present system. However, the present relationship between management and the auditor should be changed to improve the auditor's independence.

The process of appointing or changing auditors rather than the method of paying them is critical for maintaining independence. Principal responsibility for the selection and appointment of auditors and the setting of fees should be centered in the board of directors or its audit committee. The board should evaluate the relationship between the auditor and management, review and approve all arrangements for the audit, including the fee, scope, and timing, and recommend the appointment of independent auditors to shareholders.

The Commission found no evidence of a loss of independence in the performance of management advisory services by auditors for their clients and therefore proposes no

broad prohibition of those services. However, the belief held by a large minority of users of financial statements that performing management advisory services impairs independence constitutes a significant danger to the credibility of auditors. Individual auditing firms should consider the impact of the services they offer. Boards of directors or their audit committees should determine if the nature and extent of other services performed by their auditor pose a problem. The nature and extent of other services provided by the auditor should be disclosed in proxy statements.

Audit firms should neither recruit for management positions which carry discretion over the selection or retention of the auditors nor place former employees in those positions.

Management policies of public accounting firms, particularly those relating to fees and the related pressures on staff to reduce time and costs, produce disturbingly unprofessional conduct by staff members and should be improved immediately. Elements in the business environment, such as arbitrary deadlines, affect the quality of the audit, place unnecessary stress on the auditor's independence, and should be changed.

Management of public accounting firms should take steps to reduce pressures on independence which arise from time budgets that are too stringent and cost constraints that are too restrictive. Arbitrary deadlines imposed by clients should be resisted when they threaten audit quality.

The disclosures now required by the SEC when auditors are changed should accompany all audited financial statements.

THE PROCESS OF ESTABLISHING AUDITING STANDARDS (Section 10)

The present Auditing Standards Executive Committee should be replaced by an Auditing Standards Board within the AICPA composed of five to nine full-time members. Changes should be made to encourage participation from outside the profession.

Auditing standards should be restructured to recognize the changes in the audit function recommended by the Commission, to give more attention to the special needs of public accounting practice involving nonpublic companies, and to increase the quality and timeliness of the guidance provided.

REGULATING THE PROFESSION TO MAINTAIN THE QUALITY OF AUDIT PRACTICE (Section 11)

The present structure of a private profession regulated by a combination of private and governmental efforts, including the courts and the SEC, has been reasonably effective in maintaining the quality of audit practice. However, self-regulatory efforts by the profession can be substantially improved.

Secrecy should be removed from disciplinary actions and from the penalties imposed. Action on alleged violations of professional ethics should not be deferred pending the outcome of litigation except when the accused demonstrates that the litigation is directly related to the charges. Action should rarely await the outcome of appeals.

Public accounting firms should voluntarily experiment with public reporting of information that would increase understanding of their organization and operation. The AICPA should regularly publish analyses of cases involving significant audit failures.

The recent increase in litigation against auditors, while disturbing to the profession, has been a major factor in inducing greater concern over substandard performance and is an effective regulatory mechanism. However, to reduce nuisance suits, courts should be given greater discretionary authority to assess costs against unsuccessful plaintiffs. The Commission also recommends the development of reasonable statutory limitations of damages, the increased use of court-appointed masters, and the granting of temporary "safe harbors" when responsibilities of auditors are significantly extended.

1 The Independent Auditor's Role in Society

An examination of the auditor's role was necessary to provide a tentative framework for the Commission's consideration of specific issues. The consideration of those issues in turn influenced our views on the larger issue of the auditor's role. This section is a synthesis resulting from that continuous process. The independent auditor's role in society is described by both his function—what he does—and his relationships to parties interested in that function. This section is a general description of both aspects of the auditor's role based on the evidence of user expectations and the legal, economic, and social expression of expectations. The more detailed implications of this role for specific issues, such as detecting and disclosing illegal acts or association with information other than audited financial statements, and the resulting recommendations for changes in practice or standards, are discussed in later sections.

THE NEED TO CLARIFY THE AUDITOR'S ROLE

Clarifying the auditor's role can provide direction to audit practice. A statement of role makes possible orderly improvement in practice and facilitates progress toward specific goals. It provides a connection between the activities of auditors and their function in society.

Professional standards express the immediate objectives of an audit of financial statements, but they do not explicitly identify its social objectives. According to the professional standards of the American Institute of Certified Public Accountants (AICPA),

> The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.[1]

The auditor's function has also been described as lending credibility to financial information. This view conforms with the objective stated for the ordinary examination which emphasizes the expression of an opinion. However, these views do not identify the underlying purpose of an audit—its social function.

The Expectations of Users

A number of surveys have been taken to determine what the public, or knowledgeable segments of it, expect of the independent auditor and how they interpret the audit function.[2] Users of financial statements expect auditors to penetrate into company affairs, to exert surveillance over management, and to take an active part in improving the

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1. Statement on Auditing Standards No. 1 (November 1972), section 110.01 (AICPA, *Professional Standards,* vol. 1, AU section 110.01).

2. For example, see G. W. Beck, "Accountants: As Others See Us," *The Australian Accountant* 42 (February 1972): 12–21; T. A. Lee, "The Nature of Auditing and Its Objectives," *Accountancy* (England) 81 (April 1970): 292–96; Opinion Research Corporation, *Public Accounting in Transition* (Chicago: Arthur Andersen & Co., 1974); Marc J. Epstein, *The Usefulness of Annual Reports to Corporate Shareholders* (Los Angeles: Bureau of Business and Economics Research, California State University, 1975).

quality and extent of financial disclosure. In all of these areas, users seem to expect more than they believe they are receiving from auditors.

Despite efforts by many auditors to downgrade the importance of detection of fraud as an audit objective, all segments of the public—including the most knowledgeable users of financial statements—appear to consider the detection of fraud as a necessary and important objective of an audit. Users expect the auditor to be concerned with the possibility of both fraud and illegal behavior by management. They expect him to protect the interests of shareholders and be independent of management in doing so.

In analyzing the findings of these surveys and in sampling press stories on the profession, it has become clear that the auditor's importance in the economic and ethical life of the country has brought heavy pressures on him to expand his role. Such findings cannot, however, provide more than a general notion of what the auditor's role should be. The results of a few surveys, like other forms of empirical research, are seldom conclusive. Equally important, users' views are formed in an essentially cost-free environment—users do not pay for audits, except very indirectly.

Significant segments of the public have an erroneous impression of the auditor's role.[3] Several expectations are neither feasible to meet nor practical from a cost-effectiveness viewpoint. For example, many people believe that a "clean" opinion by an auditor necessarily means that the company is financially sound. Many investors feel that the auditor should not only express an opinion on the financial statements but should also interpret them in such a way that the investor can judge whether he should invest in the company. These misunderstandings cause the auditor serious difficulties and their existence emphasizes the importance of clarifying his role.

The Legal and Economic Bases of the Auditor's Role

State and federal statutes, the standards of the public accounting profession, and court decisions all contain definitions of the auditor's responsibilities. Federal statutes, and their legislative history, provide insight into the role intended for the independent auditor by Congress.[4] Professional standards are normally a distillation of the experience of many accountants in dealing with questions of responsibility. Court decisions are particularly useful because they involve consideration of competing theories of responsibility. However, they must be considered carefully because a decision is usually closely related to the facts of a particular case. Consequently, the language used in a particular decision may not be the best expression of the technical issues involved. The common thread and evolution of important ideas in court decisions must be identified.

The actions and pronouncements of regulatory agencies, particularly the Securities and Exchange Commission (SEC), are another source of information on the auditor's role. Business practices provide additional information. The logic underlying these practices must be identified by deductive analysis and then evaluated. The auditor's role should be consistent with the theory and evidence of economics and finance concerning the operations of the capital markets and the allocation of resources in the economy.

THE AUDIT FUNCTION

The independent auditor is in the most general sense an accountant. He is trained as an accountant, his professional designation is certified public accountant, and his primary

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3. See section 7 for a more extensive consideration of misunderstanding of the auditor's role and ways of achieving a better understanding.

4. See J. Wiesen, "Congressional and SEC Expectations Regarding Auditors' Duties," December 1976 (described in appendix B).

service—the audit function—has grown from the need of a variety of entities to provide an accounting to others in society.

Society's Use of Accounting and Auditing for Control

The primary function of accounting is generally thought to be the production of financial information for decision making. However, accounting has an equally important and more fundamental purpose.

Accounting as a Means of Social Control. Basically, the accounting process consists of recording all of an entity's transactions and similar relevant events, grouping those transactions and events in categories with similar characteristics, and presenting them in a set of financial statements intended to meet the needs of a variety of users.

The fact that every transaction is recorded in the accounting system is significant. This is done because the entity is accountable for every transaction. One study of the fundamentals of accounting measurement notes that

> . . . *accountability* has clearly been the social and organizational backbone of *accounting* for centuries. Modern society and organizations depend upon intricate networks of accountability which are based on the recording and reporting of these activities. This process of accounting is essential to the proper functioning of society and organizations. Accounting, therefore, starts with the recording and reporting of activities and their consequences, and ends with the discharging of accountability. This basically describes accounting, at least if we attempt to interpret the existing practice rationally. We may, therefore, say that accountability is what distinguishes accounting from other information systems in an organization or in a society.[5]

Accounting, then, is a means of achieving accountability. In the United States, chiefly through state and federal government agencies, society has used accounting systems and the information they produce as a means of control over a variety of entities. In the areas of income taxation, regulation of banks, insurance companies, and utilities, particularly in matters of rate regulation, government has relied heavily on accounting.

This reliance usually involves requirements for detailed recordkeeping. For example, almost every business, no matter what its size, must keep accounting records for such purposes as income taxes, withholding taxes, social security payments, and wages and hours worked by employees. Society has often relied, particularly in wartime, on the keeping and use of accounting records for wage and price controls, renegotiation and termination of contracts.

The federal securities acts of 1933 and 1934 rely to a great extent on the disclosure of accounting information for the protection of investors. Federal securities laws are a means of achieving accountability through required disclosure. That disclosure has been a significant factor in marshalling an enormous amount of funds from large numbers of shareholders.

The growth of accounting from a means of control within business entities to a means of controlling business entities has been described by William Werntz, former chief accountant of the SEC:

> Business accounting, for purposes of internal control of personnel, costs and policies and for reporting to inactive owners, has largely developed in the United States within the last half-century. It was impossible that this development of accounting as a control device originating in the business world would go unnoticed by legislative

5. Yuji Ijiri, *Theory of Accounting Measurement,* Studies in Accounting Research No. 10 (Sarasota, Fla.: American Accounting Association, 1975), p. 32.

> bodies and judicial and administrative officials. It was inevitable that, in the search for effective means of obtaining data about social and economic phenomena, resort should quickly be had to accounting data. Thenceforth it was but a short and logical step to reliance on the accounting process, first as a means of regularly observing the activities of economic units, and then as a means of prescribing and proscribing courses of action.[6]

The Auditor as an Agent of Social Control. Initial attempts to establish accounting standards in the United States by the Federal Reserve Board, the New York Stock Exchange (NYSE), and the AICPA involved a mixture of accounting principles, auditing procedures, and financial statement form and arrangement.[7] These early efforts reflect the close relationship between accounting and auditing and the fundamental importance of auditing in achieving accountability and control.

The demand for independent audits in the United States arose from the need of corporations to provide an accounting. A business corporation is accountable to its shareholders and creditors and a variety of other parties including the government. Corporate financial statements are reports of accountability to these interested parties.

In the early 1930s, the NYSE made an audit a listing requirement, and the federal securities acts made audits of the annual financial statements of a corporation whose securities are publicly traded a legal requirement. These requirements were adopted to assure accountability.

> In reaction to experiences of financial disaster associated with earlier forms of capitalism, the State has increasingly introduced mechanisms of public control over economic relationships and surrounded the auditing function with legislative provisions and support. In this sense, the State has endeavoured to develop countervailing power against the corporate world, using the auditor as one of its main vehicles for protection of those who need, but lack, reliable information on corporate affairs.[8]

Society uses accounting to control business entities and makes the auditor part of the process by imposing requirements for audits of accounting information.

The Relationship of Accounting, Auditing, and Entity Activities

The auditor is an intermediary in an accountability relationship. He is a third party in the relationship between the issuer of financial statements and those who use and rely on those statements. It is the auditor's position in the accountability relationship that defines his function in society:

> Directors, managers and administrators have this duty of accountability, a duty to demonstrate the quality of their performance within the constraints of the limited responsibility which has been entrusted to them. It is in this context that society has conceived the audit function whereby the performance of, and the account of their performance, submitted by the directors, managers, etc. may be subject to some scrutiny on behalf of those to whom the directors, managers, etc. are accountable.[9]

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6. William W. Werntz in Robert M. Trueblood and George H. Sorter, eds., *William W. Werntz: His Accounting Thought* (New York: AICPA, 1968), p. 451.

7. Federal Reserve Board, *Federal Reserve Bulletin,* April 1917, and *Verification of Financial Statements,* 1929.

8. D. M. Gilling, "Auditors and Their Role in Society: The Legal Concept of Status," *Australian Business Law Review* 4 (June 1976): 98.

9. David Flint, "The Role of the Auditor in Modern Society: An Exploratory Essay," *Accounting and Business Research* 1 (Autumn 1971): 288.

Financial Statements and Performance Measurement. Financial statements are accountability reports on the status and performance of an entity. Users of financial statements are interested in those statements because of their interest in the underlying economic characteristics of the entity.

The accountability relationship underlying the entity's issuance of financial statements to users implies that the financial statement amounts can be supported by records and documents of detailed transactions. This means that maintaining the accounting system from which the financial statements are produced is an important aspect of fulfilling the duties imposed by the relationship.

The relationship also determines the responsibilities of the entity to those who receive its reports. Accountability is the basis on which the rights and responsibilities of the corporation are reconciled with those of the users of the information with respect to the amount of disclosure and the methods to be used in measuring performance:

> Corporations should not be forced to disclose certain information just because that information is useful to someone. The recipient's "right to know" must be examined. Accountability can provide an important basis by which to judge whether or not the information should be disclosed.[10]

The Need for Audits. An independent audit is necessary because of the inherent potential conflict between the entity's management and the users of its financial information. Since financial statements are one of the means used to evaluate management's performance in operating the entity, management could have an incentive to bias the measurement. This bias could range from unconsciously presenting performance in a better light to outright misrepresentation.[11] Management has discretion in the preparation of financial information and in the use of assets in conducting the business. Audits have a restraining influence on management's activities in both areas. Also, users of accounting information cannot be unbiased about the way performance is measured. The auditor attempts to achieve an equitable balance among management and the various users.

Several agencies in society, such as the Financial Accounting Standards Board (FASB) and the SEC, establish rules on accounting measurement and disclosure. However, these rules, like laws and other similar requirements, need interpretation in their application. Judgment is required in selecting and applying accounting methods to measure performance, in deciding what information should be disclosed, and in estimating the outcome of uncertainties when available information is inconclusive. The auditor enforces standards for the presentation of accounting information and evaluates the judgments made by management in applying those standards.

The accounting system and the controls over it are designed to produce proper recording of performance and accountability for the assets entrusted to the entity. Users of financial statements need assurance that management has fulfilled its stewardship responsibility by establishing and supervising a system that adequately protects corporate assets. An audit provides reasonable assurance that management has fulfilled this responsibility.

An audit is a safeguard against mistakes by management and against other unintentional errors in the presentation of financial information; however, unintentional errors may also be prevented or detected by establishing additional controls within the system or by improving the supervision of the system.

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10. Ijiri, *Theory of Accounting Measurement,* p. 33.

11. This discussion is not intended to suggest that the managements of entities are not honest. Rather, it states that there is an inherent *potential* conflict between management and users of financial statements. Often an audit helps to protect management against accusations that financial statements have been presented in a biased manner.

The Consequences of an Audit

There is no unanimity about the relationship between the information presented in financial statements and securities prices.[12] When studying the objectives of financial statements, for example, the Trueblood Study Group observed that

> No study has been able to identify precisely the specific role financial statements play in the economic decision-making process.[13]

The Value of Audited Financial Statements. Much of the disagreement on the value of annual financial statements to investment decisions is traceable to extensive research on the "efficient market hypothesis." That theory states that securities markets quickly receive all publicly available information and quickly reflect it in share prices. Since annual financial statements are historically based and issued well after the occurrence of important events, they rarely contain "new" information. Annual financial statements seem to have little or no effect on securities prices. Consequently, their objectives and value are questioned.

There is general agreement, however, on several aspects of the usefulness of *audited* financial statements. Most important, *audited* financial statements provide a means of confirming or correcting the information received earlier by the market. In effect, the audited statements help to assure the efficiency of the market by limiting the life of inaccurate information or by deterring its dissemination. As discussed in greater detail in sections 6 and 9 of this report, this view of the value and nature of periodic audits has led the Commission to several conclusions on the significance of time pressures and the nature and timing of desirable levels of audit assurance.

The assurances provided by an audit hold significant information value for users of financial statements. For example, knowledge that an audit has been performed is normally assumed to affect an entity's cost of obtaining funds. One senator, testifying before a Senate committee considering imposing SEC registration requirements and annual audits on municipalities, suggested that such a requirement could have the following effects:

> The many well-run states and communities could more easily demonstrate their soundness and the deservedness of their high credit ratings and low interest rates. At the same time, any bond-issuer which was manipulating figures to show a balanced budget would be exposed. Good issues could be more easily differentiated from bad issues, and fiscally responsible units of government might then see their prudence rewarded by lower interest rates and more competitive bidding.[14]

An audit has a value independent of what users may derive from the information audited. The auditor's involvement in the processes of producing accounting information (the accounting system) and communicating that information (the financial reporting process) improves the entity's accountability. This improvement directly benefits those who have entrusted funds to the entity and indirectly increases the confidence of those who use its accounting information.

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12. The Commission held a symposium on the implications of current theories, such as the efficient market hypothesis, for the audit function. See "Roundtable Discussion on Auditors' Responsibilities and Capital Markets," May 1976 (described in appendix B).

13. Study Group on Objectives of Financial Statements, *Objectives of Financial Statements* (New York: AICPA, 1973), p. 13.

14. U.S. Senate, Securities Subcommittee of Committee on Banking, Housing and Urban Affairs, *Municipal Securities Full Disclosure Act of 1976: Hearings on S.2574 and S.2969* (Remarks of Senator Thomas F. Eagleton), 94th Cong., 2d sess., February 24, 1976, pp. 15–16.

The auditor's involvement in the accounting system and the financial reporting process exercises a restraining and directing influence. An audit may result in improved performance on the part of management and employees. Since they know they will be audited, the anticipation of the audit may influence their conduct and lead to more acceptable behavior than otherwise might have occurred.

The Cost of Audited Financial Statements. Audited financial statements cannot be perfectly accurate, in part because of the ambiguity of the accounting concepts they reflect. Income has been described as a concept that is as ambiguous as health and happiness. Even if perfection were possible, however, it is doubtful that it would be worth the price.[15] Most controls instituted by society operate imperfectly; they must operate at a rational cost.

Auditing is one control over accounting information, but there are a number of others. Accounting information is also controlled by an entity's internal control system, supervision and review of that system by management, and control over management by the board of directors. Society also exercises control through the financial press and financial analysts, through review and enforcement proceedings by regulatory agencies such as the SEC, through the threat of legal penalties, and through the securities market, which appears to place a value on reputation and stability. Resources must be allocated efficiently among these different controls. The existence of the other controls places limits on the extent of assurance needed from independent auditors.

The Constraint of the Accounting Framework

The established accounting framework includes the rules and requirements of authoritative bodies and accepted business practices. Since the auditor evaluates financial statements prepared within the constraints and limitations of that framework, he is subject to the same constraints and limitations. This accounts for many of the difficulties of auditors and some of the confusion between auditing and accounting problems.

Accounting results—the financial statements—cannot be more accurate or reliable than the underlying accounting measurement methods permit. For example, no one, including accountants, can foresee the results of many uncertain future events. To the extent that the accuracy of an accounting presentation is dependent on an unpredictable future event, the accounting presentation will be inaccurate. The *audited* accounting presentation can be no more accurate, for the auditor cannot add certainty where it does not exist. Similarly, financial statements covering shorter time periods, such as quarterly reports, are inherently less accurate than those for longer periods because they include a higher proportion of incomplete transactions. An audit of financial statements for a shorter period may otherwise improve the quality of the statements, but it cannot overcome that inherent limitation on relative accuracy.

In general, if an accepted accounting principle, such as historical cost, has limitations, audited financial statements remain constrained by those limitations.

Since a number of parties have an interest in the measurement of the performance of an entity and their interests may conflict, there may be pressure to bias accounting measurements of performance. Authoritative bodies have recognized this problem. The measurement of earnings and financial position are often structured to avoid manipulation by the adoption of unambiguous rules of measurement or restriction of the number of permissible rules of measurement. For example, the FASB's decision to require that all costs of research and development be charged off in the period incurred rather than

15. Congress was aware of the tradeoff between cost and perfection at the time it enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. See Wiesen, "Congressional and SEC Expectations Regarding Auditors' Duties" (described in appendix B).

to permit the option of deferral to future periods when their benefits would be received could be viewed as an attempt to make that measurement less subject to bias. This property has been referred to as the "hardness" of the accounting measurement.[16]

In spite of the efforts of authoritative bodies, accounting measurements do not have a uniform degree of hardness. Only a portion of the activities of entities are covered by existing accounting rules, and not all accounting rules can be applied unambiguously. Many accounting measurements require an interpretation of the facts being accounted for, and there can be substantial disagreement on proper interpretation.

The varying degrees of hardness of accounting measurement have a dual effect on the audit function. A "hard" measurement is less subject to outside bias. However, if the resulting measurement principle represents an arbitrary solution to a problem that is inherently uncertain, the measurement may inject a persistent bias. For example, all companies now show no asset for the possible future value created by research and development expenditures. The audit function is improved by the elimination of outside pressures, but there is a tradeoff between the hardness of a measure and the accuracy of measurement in particular cases. A persistent bias that affects all companies is a part of the accounting framework. On the other hand, when an accounting measurement is not sufficiently "hard," the required interpretation places an additional burden on the auditor. The judgment the auditor should exercise in such circumstances is discussed in section 2 of this report.

The auditor must therefore allocate his resources between two types of service. He audits the accounting system that produces the accounting information, but he often also provides guidance, consultation, and advice on the preparation of that information.[17] The number and complexity of the accounting reports that an entity must prepare may increase the cost of an audit without increasing the amount of audit work because of the resources the auditor allocates to assistance in the preparation of information.

THE AUDITOR'S RELATIONSHIP TO PARTIES INTERESTED IN THE AUDIT FUNCTION

The auditor's function determines his responsibilities. His relationships to parties interested in that function determine to whom those responsibilities are owed and when. Auditors in the United States have since the turn of the century acknowledged responsibilities to several parties other than those who directly engage them and pay their fees.

As an intermediary in an accountability relationship, the auditor must be independent of both the preparers and the users of financial information. Independence is necessary because the auditor must counteract the bias that may influence management's measurement of performance and equitably resolve conflicts among users.

The Auditor's Relationship to Management

The relationship with management is the most complex of the auditor's relationships. It includes many aspects traditionally associated with the direct contractual relationship

16. Ijiri, *Theory of Accounting Measurement,* pp. 35–40.

17. The auditor may furnish advice on accounting methods applicable to transactions that management is planning. His assistance is often needed in the difficult process of wording narrative disclosures to accompany and explain financial statement amounts. Often auditors are also particularly knowledgeable about the reporting requirements of regulatory agencies. Generally, the amount of this type of assistance an entity requires depends on its size. Larger entities have larger and more sophisticated accounting departments and more skilled accounting personnel and require less assistance. The assistance required by a small company may be substantial.

a professional has with a client. Management, however, does not operate as an independent contractor for the auditor's services, but acts only as a representative of the entity audited. The entity's resources are used to compensate the auditor, and, though management often arranges for the engagement, the auditor is either elected by, or his selection is ratified by, the board of directors or shareholders.

Since the need for audits arises from the inherent potential conflict between management and users, the respective roles of management and the auditor in the issuance of audited financial statements must be kept distinct.

Responsibility for Financial Statement Representations. The traditional division of responsibility places direct responsibility for financial statements on management. The auditor's responsibility is to audit the information and express an opinion on it. This division of responsibility has been reflected in statutes requiring audits and in the professional standards of auditors.[18] Nevertheless, it has been challenged recently, and suggestions have been made that all or a substantial portion of the responsibility for determining the financial representations about the entity should be charged to the independent auditor.[19]

That the present division of responsibility has endured the test of time and the scrutiny of regulatory agencies and the courts might be reason enough for leaving it unchanged. But beyond this, the rationale of the relationship is sound. Public policy requires that management acknowledge its responsibility for representations in financial information about the entity. Unlike the auditor, management has firsthand knowledge of the transactions and events being reported and should be responsible for seeing that they are reported properly.

The auditor may provide advice and counsel to management in the preparation of financial information. However, this form of assistance is distinctly different from management's responsibility to make the decisions involved in both processing accounting information and making representations about the entity's status and performance.

It is impossible to separate other aspects of the processing of accounting information from the selection of accounting principles. Selection of many accounting principles is an integral part of the accumulation and classification of data to be presented. Were the auditor to be responsible for processing the information he is expected to audit, the fundamental concept of an independent evaluation of that information would be threatened.

Management's experience, familiarity with the entity, and continuous involvement in its operations make management better able than the auditor to make the initial judgments required. Preparing financial statements requires an assessment of the probabilities and potential implications of uncertain future events. Management's knowledge and experience are necessary to make such estimates. It is management's responsibility to support the measurements made and the auditor's responsibility to challenge those measurements and evaluate the adequacy of management's support.

The Auditor's Attitude Toward Management. The auditor should be neither an advocate on management's behalf nor an adversary. Unfortunately, only these two extremes can be

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18. "The financial statements are the responsibility of the client and all decisions with respect to them must ultimately be assumed by the client" (SEC Accounting Series Release No. 126, "Independence of Accountants," July 5, 1972). "The financial statements . . . [are] the representations of management" (Statement on Auditing Standards No. 1, section 110.02 [AICPA, *Professional Standards,* vol. 1, AU section 110.02]).

19. For example, see Melvin Aron Eisenberg, "Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants," *California Law Review* 63 (March 1975): 426–32.

eliminated with ease. The auditor must have extensive contact with management. He needs to know management's business plans and decisions because of the effect they may have on financial statements. For example, explanations from management are needed about the way that its goals have affected such matters as the amount of inventories or receivables.

The nature of the audit function requires a confidential relationship.[20] Frank communication with management is often necessary to obtain sufficient evidence. For example, the auditor's evaluation of the amount provided for income taxes normally requires a discussion of many possibilities that require conjecture and speculation about challenges the Internal Revenue Service may make to management's determination of taxes. If the details of this exchange were routinely disclosed to the IRS, management would not permit the discussions.[21]

A commissioner of the SEC has explained the proper relationship between the auditor and management as follows:

> An auditor drawn from the private sector and trusted by management can work cooperatively and constructively with management in developing internal controls and procedures, and in producing a financial statement which reflects the realities of the particular company. An adversary relationship can be avoided, and this should produce a better audit.[22]

Despite the need for a constructive and confidential relationship with management, the auditor must approach the engagement with an attitude of professional skepticism. He needs to evaluate critically the accounting principles selected to measure performance, the estimates of uncertainties that must be made in applying many accounting principles, and the extent of disclosure necessary.

However, the auditor cannot assume that management is dishonest. The cost of conducting an audit based on that assumption would be many times that of present audits. The auditor would be unable to rely on the accounting system and the controls over it and would need to question the legitimacy of every supporting document or record. Since in the vast majority of cases management is honest, conducting all audits on the basis of a contrary assumption would impose an enormous cost on society.[23]

The distinction between investigations when fraud is suspected and ordinary audits is well established in business practice.[24] For example, the IRS makes a distinction between regular agents who ordinarily conduct audits of taxpayers and special agents who are called in only when fraud is suspected.

Even though it would be impractical to conduct audits on the basis of an assumption of dishonesty, the auditor cannot assume management's honesty. In preparing financial statements, management must interpret many facts to account for transactions, choose among accounting methods, and make estimates involving the varied uncertainties that

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20. This confidential relationship should be distinguished from a privileged relationship recognized by law.

21. United States et al. v. Coopers & Lybrand et al., Brief of Johns-Manville (Respondent in Intervention—Appellee) (C.A. 10, 76–1066), pp. 24–32.

22. Philip A. Loomis, Jr., "The Independence of the Public Accountant," remarks at seminar of Florida Institute of Certified Public Accountants, Miami, Fla., December 13, 1974.

23. While the Commission has no precise information on the subject, the increased cost to society of audits conducted on the assumption of management dishonesty would seem to far exceed present losses from undetected management dishonesty. In short, it would be an unwarranted social investment.

24. Norman C. Grosman, "How to Audit a Known Fraud," *Touche Ross Tempo* 22, no. 1 (1976): 12–18.

arise in business. Thus, there are many possibilities for ill-intentioned or simply biased actions, involving either outright misrepresentation or, more commonly, taking advantage of the many gray areas in accounting measurement.

The Auditor's Relationship to Financial Statement Users

The independent auditor is responsible to a variety of interested parties, but his responsibilities vary in nature and extent. He does not have the same degree of responsibility to all those who find financial statements useful.

Much of the auditor's work involves equitably resolving the conflicts that arise among interested parties. Conflict may not be limited to that between the reporting entity and those to whom it is accountable, but may also arise among users of financial statements. These potential conflicts have been described as follows:

> The conflict of interest that surrounds performance measurement is not limited to the relationship between the entity and the recipient of the entity's performance measure. A conflict may arise between past and present shareholders after some shareholders sell their shares based on a poor earnings report. When there is a dispute over the maximum amount the corporation can distribute as dividends, the conflict may be between shareholders and creditors. Perhaps consumers will disagree with shareholders of a regulated corporation on a "fair" return on shareholders' investment, or the corporation may vie with the Internal Revenue Service over taxable income, or divisions may challenge headquarters about incentive compensations that managers are entitled to receive based on divisional profit.[25]

There are, however, some differences in the needs of those with an existing financial commitment in the entity and those who have only a potential interest in making a commitment. Potential shareholders and potential creditors have not entrusted funds to the entity, and they are not owed an accounting for the use of those funds; their rights relate primarily to the quality of the information they receive. Existing shareholders and creditors are owed an additional duty with respect to management's stewardship over corporate assets.

The Auditor's Relationship to the Board of Directors

A corporation's board of directors has a duty to see that the corporation is operated in the best interest of the shareholders. Management has a similar responsibility, but regulatory agencies, the courts, and the public in general are looking increasingly to outside directors to represent shareholders more actively.

An active board of directors with a significant proportion of independent outside directors can also be of benefit to an independent auditor in fulfilling his responsibilities. Such a board is necessary for effective monitoring of management's performance and can balance the auditor's relationship with management.

Before 1890, few audits in the United States were made for other than owner-managed companies. In the last decade of the nineteenth century, separation of ownership and control in large industrial corporations led to demands for protection of the public and investors. However, the twenties saw a significant shift in the attitude toward auditing. No longer did the public sector stress the need for corporate accountability. Auditors were encouraged to view their function as advisors to the business community. Regulatory agencies such as the Federal Trade Commission, and administrative bodies such as the Department of Commerce, promoted cooperation among businessmen as a means

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25. Ijiri, *Theory of Accounting Measurement,* p. 35.

of eliminating "cutthroat competition," and auditors were asked to foster such cooperation. Thus, during the twenties audits were viewed in large part as a service to management.[26]

The attitude that developed in the twenties "may have led to an inadvertent identification by independent auditors of the interests of management with the interests of the company"[27] that did not change adequately with the shift in emphasis back to accountability in the thirties.

Management is frequently the only interest in the company with which the auditor has extensive contact. Discussions of the accounting system, controls over it, and accounting problems are often settled solely between management and the auditor. The engagement of the independent auditor is usually arranged by management; his fee is negotiated by management; and his dismissal is usually at management's initiative. The auditor respects management's confidences and knows management's goals and dilemmas. This may be necessary but it has unfortunate potential consequences. It can lead an auditor incorrectly to look on the interests of management as if they are the same as the interests of the company.

This relationship between management and the auditor is a potential threat to the auditor's ability to remain independent. Indeed, the relationship has often been questioned by critics of the public accounting profession. It is not difficult to understand why some question how the auditor can remain independent in the face of such a relationship. This problem is considered in detail in section 9 of this report.

Although other measures may be needed, active outside directors can go a long way toward balancing the auditor's relationship with management. The possibility of abuse of accounting methods is a key area for outside directors to probe.[28] The board must monitor management's stewardship over corporate assets. Outside directors should consider the corporation's total audit needs and balance the work of internal auditors and independent auditors in evaluating controls and management's supervision of them. In this area, the board and auditors are natural allies. The role of the independent auditor in improving corporate accountability can be significantly strengthened by closer, more active cooperation between boards of directors and auditors. For example, directors should regularly receive a report on the company's accounting system and the controls over it from the independent auditor.

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26. This historical analysis was prepared and researched for the Commission by Barbara D. Merino of New York University.

27. R. K. Mautz, "Toward a Philosophy of Auditing," in Howard Stettler, ed., *Auditing Looks Ahead,* Touche Ross/University of Kansas Symposium on Auditing Problems (Lawrence, Kan.: University of Kansas School of Business, 1972), p. 86.

28. The SEC, for example, recently criticized two outside directors for failure to become familiar with the accounting practices and procedures used by a company. In the *Stirling Homex* case, the Commission stated: ". . . they did not obtain a sufficiently firm grasp of the company's accounting practices and other aspects of the company's business related thereto to enable them to make an informed judgment of its more important affairs or the abilities and integrity of its officers" (Sam Harris, "Directors of Industrial Companies: Special Problems" *The Business Lawyer* 31 [March 1976]: 1239).

2 Forming an Opinion on Financial Presentations

There is disagreement and misunderstanding among the courts, independent auditors, and users of financial statements concerning the responsibility the auditor should assume in forming an opinion on financial statements. The role of generally accepted accounting principles in the auditor's evaluation, the responsibilities implied by generally accepted auditing standards, and the meaning of the auditor's opinion all have been debated.

THE EXPECTATIONS OF USERS

The financial press and the courts have criticized auditors for not exercising appropriate judgment in evaluating financial statements.[1] Users expect the auditor to evaluate the measurements and disclosures made by management and to determine whether financial statements are misleading, even if they technically conform with authoritative accounting pronouncements.[2]

Often the expectations of users have been interpreted and described as demands that financial statements be fair. In fact, the auditor's standard report represents that in the auditor's opinion the information in the financial statements is "presented fairly . . . in conformity with generally accepted accounting principles." However, too much emphasis on this aspect of the issue diverts attention from the underlying and more significant question of the judgments the auditor should make in evaluating financial statements.

Financial statements should, of course, be fair in the ethical sense of being prepared honestly and responsibly. Fairness is a quality that should underlie the preparation of financial statements, but it is not a property that can be objectively measured by the auditor. One academic accountant contends that those who have argued that fairness should be the basis of financial reporting never define what they mean by fair. He argues that "fairness is an empty box" and suggests that what certain advocates of fairness mean by fair is something that agrees with their biases.[3]

1. For example, in the district court decision in the *Herzfeld* case, the court criticized the auditor's performance in these words: "Our inquiry is properly focused not on whether . . . [the] report satisfies esoteric accounting norms, comprehensible only to the initiate, but whether the report fairly presents the true financial position . . . to the untutored eye of an ordinary investor." (Herzfeld v. Laventhol Krekstein Horwath and Horwath, U.S.D.C., S.D.N.Y., No. 71, Civ. 2209, May 29, 1974 [CCH Fed. Sec. L. Reptr., paragraph 94,574].) Other pertinent legal decisions are analyzed in Philip L. Radoff, "Court Decisions on Auditors' Liability: The Role of GAAP and GAAS," September 1975 (described in appendix B).

2. For example, in an August 3, 1972, letter transmitting the Securities and Exchange Commission's *Staff Study of the Financial Collapse of the Penn Central Company* to the Special Subcommittee on Investigations of the House Committee on Interstate and Foreign Commerce, William J. Casey, then chairman of the SEC, stated, "The whole pattern of income management which emerges here is made up of some practices which, standing alone, could perhaps be justified as supported by generally accepted accounting practices, and other practices which could be so supported with great difficulty, if at all. But certainly the aggregate of these practices produced highly misleading results." Similar beliefs are expressed in surveys of users. (See Lewis Davidson, "The Role and Responsibilities of the Auditor: Perspectives, Expectations, and Analysis," 1975 [described in appendix B].)

3. Carl L. Nelson, review of *More Debits Than Credits,* by Abraham J. Briloff, in *Business Week* (March 8, 1976): 12.

"Fair" is often used loosely as a synonym for other characteristics of financial information. In some cases, it is intended to convey the concept of adequate disclosure. In other cases, it is invoked to advocate the concept of substance over form. Financial statements should possess these qualitative characteristics and others, but understanding would be improved if attention were focused directly on the desired qualitative characteristics.

Some auditors have argued that "present fairly," in the auditor's standard report, is used to convey the idea that financial statements cannot be completely accurate or precise because of inherent imprecision in the accounting process.[4] Some users may expect financial statements to measure financial position and earnings with a degree of precision that is not attainable. Precise measurement is impossible because of the complexity of the economic activities reported on in financial statements and the uncertainty of future events that affect current financial information. However, it is unreasonable to expect a short phrase in the auditor's report to convey that message.[5]

We have studied the extensive literature on the significance of the words used in the auditor's report and considered their interpretation by auditors and users. We have also noted attempts to analyze the meaning of the phrase, "present fairly . . . in conformity with generally accepted accounting principles."[6] Our study persuaded us that these efforts to analyze terminology are not fruitful. We believe a more useful approach is to explore the nature of generally accepted accounting principles and generally accepted auditing standards and to analyze the judgments and decisions they require. One of the most effective ways of describing, clarifying, or considering expansion of the auditor's responsibilities in forming an opinion on financial statements is to focus on the judgments and decisions that must be made about the selection and application of accounting principles.

THE GUIDANCE PROVIDED BY GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Management is responsible for presenting financial statements that reflect underlying events and transactions in conformity with generally accepted accounting principles. Because financial statements are one of the means used to evaluate its performance, management may select and apply accounting principles that give a biased portrayal of the entity's financial position and earnings. The auditor evaluates the appropriateness of management's selection and application of accounting principles. The principal value of the independent auditor's opinion on financial statements is that his judgment is not influenced by self-interest in the measurement of the performance of the entity presented in the statements.

Both the auditor and management use the same body of generally accepted accounting principles in performing their respective functions. However, the auditor brings a different perspective to his evaluation of management's selection and application of ac-

4. For an analysis of the difficulty of defining "present fairly" and an explanation of the meanings attributed to the term by auditors, see D. R. Carmichael, "What Does the Auditor's Opinion Really Mean?" *The Journal of Accountancy* (November 1974): 83–87.

5. Possible misunderstanding of the auditor's report and ways of achieving better communication are explored in section 7 of this report. The specific subject of imprecision in financial statements caused by uncertainties is discussed in section 3.

6. Specific wording is needed to express the auditor's evaluation. The wording of the auditor's report is considered in section 7.

counting principles. The auditor's responsibility is to make an objective appraisal of the accounting methods chosen, the estimates made, and the information disclosed.[7]

The Role of Pronouncements

Generally accepted accounting principles are "the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time."[8] They are not limited to the principles in pronouncements of authoritative bodies such as the Financial Accounting Standards Board (FASB). They also include practices that have achieved acceptance through common usage as well as principles in nonauthoritative pronouncements of bodies of recognized stature such as the Accounting Standards Division of the American Institute of Certified Public Accountants. Too narrow a view of the scope of those principles by auditors and preparers has contributed to the criticism of both generally accepted accounting principles and auditors.

The Importance of Judgment

Pronouncements on generally accepted accounting principles often include guides for their application to achieve financial statements that, within the existing accounting framework, reflect the substance of transactions and create an overall presentation consistent with underlying economic events and conditions. These guides require the use of judgment in the selection and application of accounting principles. Clearly defined and accepted guides to decision making are needed to avoid judgments based on personal preferences or biases rather than on criteria established collectively through due process. Judgments based on personal preference would inject a degree of variability into financial statements that would reduce their usefulness.

The existing accounting framework encompasses notions such as matching, realization, and historical cost. Some criticisms of auditors' judgments are, in fact, criticisms of the accounting framework. However, preparers of financial statements and independent auditors should not be expected to make the judgment that a departure from the existing accounting framework should be made.[9] The framework provides enough flexibility through disclosure or other supplemental reporting to permit the preparation of sufficiently informative financial information. Judgment should be exercised within the existing accounting framework, not independently of it. Fundamental changes in that framework by authoritative bodies may sometimes be necessary, and those changes may require preparers and auditors to make different types of judgments. Such changes would not, however, eliminate the need for judgment in preparing and evaluating financial statements.

Accounting and auditing pronouncements[10] state or imply the need for informed

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7. The auditor's responsibility to evaluate the decisions made by management in recording the effect of uncertainties for which a reasonable estimate can be made is part of his responsibility to evaluate management's selection and application of accounting principles. The auditor's responsibility when an estimate cannot be made is considered in section 3.

8. Accounting Principles Board Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (October 1970), paragraph 138 (AICPA, *Professional Standards,* vol. 3, AC section 1026.02).

9. Departures from the existing accounting framework need to be kept distinct from departures from specific accounting pronouncements which may be required in some circumstances. (See Rule 203 of the AICPA *Code of Professional Ethics* [AICPA, *Professional Standards,* vol. 2, ET section 203.01].)

10. Authoritative accounting pronouncements are promulgated principally by the FASB. Authoritative auditing pronouncements, which interpret generally accepted auditing standards, are promulgated by the Auditing Standards Executive Committee of the AICPA's Auditing Standards Division. The process of setting auditing standards is considered in section 10 of this report.

judgment "as to the relative appropriateness of acceptable alternative principles and methods of application in specific circumstances of diverse and complex economic activities."[11] Thus, management's selection and application of accounting principles require decisions based on judgment as to the appropriateness of the principles to the underlying events or transactions considered both individually and collectively.

The auditor is responsible for determining whether management's judgments were appropriate. This requires much more than the mechanical application of specific rules. For example, if a transaction appears to have been structured to meet the literal but not the substantive requirements of accounting pronouncements, the auditor should object and insist on revision of the financial statements or qualify his opinion.

Judgment pervades accounting and auditing. It is exercised in considering whether the substance of transactions differs from their form, in resolving questions of materiality and adequacy of disclosure, in deciding whether an estimate can be made of the effects of future events on current financial statements, and in allocating receipts and expenditures over time and among activities.

Pronouncements often specify the judgment required in the selection or application of specific principles in varying circumstances. One of many examples is Accounting Principles Board Opinion No. 11, *Accounting for Income Taxes,* which specifies the accounting for the tax benefit of an operating loss carryforward. The requirement to use judgment to determine whether to recognize the tax benefit in the current period is explicit in the opinion.

Deficiencies in Generally Accepted Accounting Principles

The public accounting profession has tried to develop detailed accounting principles to reduce the number of acceptable alternatives and to meet the changing needs of evolving economic conditions. Even so, there are many kinds of events or transactions for which authoritative accounting bodies have not specified one alternative as preferable or the circumstances in which each of several alternatives is appropriate. Thus, the guidance provided by detailed accounting principles in authoritative pronouncements is incomplete. In part, this incompleteness arises because authoritative accounting bodies have not always reacted quickly enough to changes in the business environment, to emerging practice problems, or to inappropriate application of existing accounting principles to new types of transactions and other events.

It is, at the same time, unreasonable to expect an authoritative accounting body to develop rules that will always deal adequately with complex and rapidly changing business conditions, particularly since agreement has not yet been reached on the objectives of financial reporting.[12] It is particularly unreasonable to expect authoritative rules to cover

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11. Accounting Principles Board Opinion No. 22, *Disclosure of Accounting Policies* (April 1972), paragraph 5 (AICPA, *Professional Standards,* vol. 3, AC section 2045.05). See also Accounting Principles Board Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (October 1970), paragraph 124 (AICPA, *Professional Standards,* vol. 3, AC section 1025.11), and Statement on Auditing Standards No. 5, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report* (July 1975), paragraph 4 (AICPA, *Professional Standards,* vol. 1, AU section 411.04).

12. The FASB presently has on its agenda the topics of materiality and the conceptual framework of financial accounting, including the objectives of financial statements. We encourage prompt completion of the projects because of their importance to the development of more definitive statements of accounting principles and auditing standards.

all aspects of disclosure. The standard of adequate disclosure[13] is intended to assure the presentation of sufficient information and explanation to enable the user to understand the events and transactions reported on in financial statements. The adequacy of disclosure cannot be evaluated solely on the basis of detailed principles as they appear now or as they may appear in the future in authoritative pronouncements.

Limited Conception of Generally Accepted Accounting Principles

The difficulties created by using conformity with generally accepted accounting principles as a criterion are caused in part by deficiencies in those principles. They are also the result of the narrow view sometimes taken of generally accepted accounting principles. Managements and independent auditors have failed at times to recognize that generally accepted accounting principles include more than those found in pronouncements of authoritative bodies.[14] What is more important is that management and independent auditors have sometimes failed to recognize and exercise the crucial element of judgment required by generally accepted accounting principles.

RECOMMENDATIONS ON EXTENSION OF GUIDANCE IN AUDITING STANDARDS

The auditor's evaluation of financial presentations consists of a series of decisions on the appropriateness of the accounting principles applied with respect to the particular events and transactions and to the financial statements taken as a whole. Traditionally, auditors have been expected to exercise significant judgment in evaluating the presentation of accounting information in financial statements.

Before the formulation of accounting principles by authoritative bodies, auditors, according to the 1912 edition of Montgomery's text on auditing, were expected to exercise their judgment "to ascertain the actual financial condition and earnings of an enterprise."[15]

13. The third standard of reporting under generally accepted auditing standards is, "Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report" (Statement on Auditing Standards No. 1 [November 1972], section 430.01 [AICPA, *Professional Standards,* vol. 1, AU section 430.01]). In the two key legal decisions that have been interpreted as rejecting conformity with generally accepted accounting principles as the sole test for financial statements, the deficiency in the financial statements was inadequate disclosure. Authoritative pronouncements, however, do not, and should not be expected to, specify all the disclosures necessary in financial statements. Thus, when pronouncements are not specific about the disclosures necessary in particular circumstances, conformity with authoritative pronouncements cannot conclusively demonstrate conformity with professional standards. (The two decisions are *Herzfeld* [see footnote 1] and *Continental Vending* [U.S. v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied,* 396 U.S. 1025 (1970)].)

14. Statement on Auditing Standards No. 5, paragraph 6 (AICPA, *Professional Standards,* vol. 1, AU section 411.06), states, "In the absence of pronouncements [by authoritative bodies] . . ., the auditor should consider other possible sources of established accounting principles. . . ." The very process of articulating accounting principles may have led to too great a reliance on authoritative literature and a belief that anything is acceptable in the absence of authoritative literature. Auditors often face client demands to "show us where it says we can't (or, alternatively, "must") do that." Such demands clearly indicate an inadequate understanding of the scope of generally accepted accounting principles.

15. Robert H. Montgomery, *Auditing, Theory and Practice* (New York: The Ronald Press Company, 1912), p. 9. The several editions of this book comprised the most significant series of auditing texts in the United States for many years. The phrase "actual financial condition and earnings" should not be interpreted as a belief that absolute accuracy was attainable. Montgomery and others writing at the time stressed the point that financial statements were largely matters of opinion. The phrase is used to emphasize the need to exercise judgment in measuring the economic events and conditions underlying financial statements.

In 1934, the AICPA first formally promulgated accounting principles, and in 1939 the first Accounting Research Bulletin was issued.[16] The development of a body of authoritative pronouncements on accounting principles may have made the auditor's judgments less difficult. However, the increase of guidance on specific accounting principles may also have diverted attention from the need for guidance on the exercise of judgment in applying both accounting principles and, more important, auditing standards.

Statement on Auditing Standards No. 5 provides some broad guidance for the auditor's evaluation of financial statements. That guidance needs to be improved in three specific areas: evaluating the appropriateness of accounting in areas for which there are no detailed accounting principles, evaluating the appropriateness of accounting in areas in which there appear to be alternative accepted accounting principles, and evaluating whether financial statements taken as a whole have been prepared in a biased manner or are otherwise misleading.

Direction in the Absence of Detailed Accounting Principles

If no established accounting principle is prescribed for a specific event or transaction, SAS No. 5 advises the auditor to evaluate the presentation on the basis of an analogy to similar events or transactions for which principles have been established. However, only limited guidance is given on the application of reasoning by analogy.

The auditor should be strongly influenced but not constrained by the existence of established principles for analogous events or transactions. To illustrate, before 1973 there were no established principles to account for television film licensing agreements. In that year, the AICPA issued an industry accounting guide, *Accounting for Motion Picture Films,* that established revenue recognition principles for film licensors (producers). The problem remained, however, for film licensees (the broadcasting industry).

Two years later, a Statement of Position on "Accounting Practices in the Broadcasting Industry" was issued by the AICPA's Accounting Standards Division. During that two-year interval, the auditor of a broadcasting company should have given substantial, though not conclusive, weight to the fact that principles had been established for the licensor and that the licensee's transaction was analogous.

This does not imply that accounting for both sides of a transaction must be parallel, but direction should be sought in the principles established for one side of the transaction. Similarly, principles established for one type of entity, such as hospitals, should be considered in evaluating principles selected for similar entities for which principles have not been established, such as nursing homes.

Reasoning by analogy should not be equated with reliance on precedent. Common usage is one source of generally accepted accounting principles, but unlike the common law, which may rely on a single precedent, an accounting principle should require more than precedent to become generally accepted. In some cases, managements have searched for principles previously applied only in rare or unusual circumstances, and some auditors have too willingly accepted this dilution of the substance of generally accepted accounting principles.

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16. George O. May, who was one of those instrumental in establishing the first accounting rule-making body in this country, conceived of accounting methods or practices as postulates, derived from experience and reason, that become "principles of accounting" only after they have proved to be useful and become generally accepted. In reporting on financial statements, the auditor had to test the principles selected by management for their general acceptance, not for their support in promulgations of rule-making bodies. Rule-making bodies did not exist when the term *principles* first came into use in the auditor's report as a result of correspondence in 1932 between the American Institute of [Certified Public] Accountants and the New York Stock Exchange. (George O. May, *Financial Accounting: A Distillation of Experience* [New York: The Macmillan Company, 1943], pp. 38 and 40.)

Even if auditors reason by analogy properly, different auditors may nevertheless conclude on occasion that different accounting principles are appropriate in similar circumstances. This has sometimes led to the selection of auditors on the basis of their acceptance or rejection of a particular accounting principle. Selection of auditors on this basis could result in a deterioration of accounting principles and a tendency for auditors to abstain from judgments they are competent to make. Such a result can only serve to erode users' confidence further, and modification may be needed in the means by which independent auditors are changed. This possibility is considered in more detail in section 9 of this report.

Direction for Selecting Among Alternatives

The auditor's evaluation also requires a decision if two or more alternative principles are generally accepted and criteria for selecting among them are insufficient. Often there is a basis for evaluating the alternatives.

The auditor should analyze the underlying facts and circumstances to determine whether one of the alternatives would result in a presentation more closely in accord with the substance of a transaction or event. The required analysis should not be confused with the choice of a particular principle for reasons of personal bias. Also, the analysis would not be sufficient if the choice was based solely on the conformity of a principle with general concepts, such as "conservatism" or "matching." The relative importance of such concepts has not been determined and their implications have not been delineated. The auditor should also consider whether accomplishing an objective other than informing users—such as reducing or postponing income taxes—has inappropriately predominated in the choice of accounting principles. Management's business judgment and planning may appropriately enter into a choice among alternative accounting principles, but should not supplant other circumstances pertinent to measuring the performance of the entity.

Deciding among alternatives in the absence of specific guidance is admittedly difficult. A basic condition must be that the judgment have an objective basis. There are many examples of auditors' relying on objective bases and making such judgments with skill and competence.[17] The position that no objective basis exists to choose among alternative principles should not be taken lightly. It should be carefully considered and documented.

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17. Two such examples can be cited by way of illustration: (1) Before the issuance of Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (March 1971), the equity method of accounting for investments in unconsolidated subsidiaries was given preference by Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (August 1959), but the cost method remained an acceptable alternative. In the period between the issuance of these two pronouncements, many auditors believed that the equity method provided a more realistic presentation of income, particularly if dividends paid to the parent company differed significantly from the subsidiary's income, and in many cases clients were persuaded to adopt the equity method; (2) Before the adoption of Accounting Principles Board Opinion No. 15, *Earnings Per Share* (May 1969), Opinion No. 9, *Reporting the Results of Operations* (December 1966), required that "when an outstanding security clearly derives a major portion of its value from its conversion rights or its common stock characteristics, such securities should be considered 'residual securities' and not 'senior securities' for purposes of computing earnings per share." Without specific guides in Opinion No. 9 for determining the meaning of "clearly derives a major portion," the auditing profession coalesced around the use of a test whereby a security's market value was compared to its value in the absence of the conversion privilege (commonly referred to as its "investment value"). The only substantial disagreement within the profession was over the precise relationship between market value and investment value.

In both cases, many independent auditors were able to determine, on an objective basis, which alternative was the appropriate principle in the circumstances. That the exercise of separate and independent judgments led to substantial uniformity of practice is not the point here. What is significant is that judgment was exercised in areas in which alternatives existed or pronouncements were unclear.

Nevertheless, in two types of situations the auditor should not be expected to judge the choice among alternatives in the absence of direction in authoritative pronouncements. First, authoritative accounting bodies have considered the alternatives at length and have not been able to reach a conclusion as to the preferability of one or more alternatives, as, for example, in accounting for the investment tax credit.[18] Second, extensive analysis by competent accountants has shown that all the generally accepted alternatives are equally arbitrary, such as the several generally accepted methods of depreciation and inventory costing.[19] In both situations, an auditor can reasonably conclude that no objective basis exists for evaluating management's selection and application of alternative accounting principles.

The mere absence of authoritative literature specifying how the choice among alternatives should be made is not sufficient grounds for the auditor to accept management's selection. He should not accept management's selection of an accounting principle simply because its use is not forbidden, and he should not accept management's rejection of a principle simply because it is not required.

When management decides to change an accounting principle, use of an alternative must be justified on the basis that the new principle is preferable.[20] If the required justifi-

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18. Accounting Principles Board Opinion No. 4, *Accounting for the "Investment Credit"* (March 1964), paragraph 10 (AICPA, *Professional Standards,* vol. 3, AC section 4094.17).

19. Arthur L. Thomas, in *The Allocation Problem in Financial Accounting Theory,* Studies in Accounting Research No. 3 (Sarasota, Fla.: American Accounting Association, 1969), reaches this conclusion regarding conventional depreciation methods. Auditors have generally taken the position that there is no basis for judging the preferability of one depreciation method over another, and the Thomas study supports this position. (The study does not support the position occasionally taken by some auditors that they are also unable to judge the validity of management's estimates of the useful lives of depreciable assets.) However, the Thomas study concludes that all allocations are arbitrary, not just those concerned with the allocation of asset costs over time, and that this results in severe limitations on the usefulness of financial statements. That implication is not presently accepted in authoritative accounting pronouncements or by most auditors. Generally, these methods involve allocation of costs or revenue over time or among products. Any difference caused by the choice among allocation methods will affect the measurement of income only over a short period of time.

20. Accounting Principles Board Opinion No. 20, *Accounting Changes* (July 1971), paragraph 16 (AICPA, *Professional Standards,* vol. 3, AC section 1051.16), states, "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable." Paragraph 17 requires disclosure in the financial statements of the justification and specifies that it "should explain clearly why the newly adopted accounting principle is preferable."

The SEC's Accounting Series Release No. 177 (September 10, 1975) provides in part that "When a business enterprise changes an accounting principle . . . the first [quarterly financial] report filed subsequent thereto must include as an exhibit a letter from its independent accountants indicating whether or not the change is to an alternate principle which in his judgment is preferable under the circumstances."

These provisions of ASR No. 177 have met considerable opposition from independent auditors, and Arthur Andersen & Co. filed suit in the Northern District of Illinois to enjoin enforcement of them.

The Commission on Auditors' Responsibilities has not specifically considered the SEC's position. Its conclusions in this section were unanimously agreed to well before the present dispute. To avoid ambiguity, however, we note that the conclusions are generally in accord with the position of the SEC. However, we believe that the SEC's emphasis on changes in accounting principles is misdirected.

The same basic concepts are always applicable to the selection and application of accounting principles. The auditor should continually re-examine the accounting principles used by his clients. Changes in accounting principles should require no exceptional consideration. However, since a requirement that the auditor always attempt to determine preferability has not been in effect, its implementation might well involve a significant number of accounting changes, on a non-recurring basis.

cation were not given, the auditor would be expected to qualify his opinion. However, the auditor's evaluation of management's choice among alternative principles should not be different simply because there has been a change. The auditor should have the same obligation to analyze the underlying facts and circumstances for accounting principles for which alternatives exist even in the absence of a change.

When there are alternative accounting principles for the same type of event or transaction, the choice among alternatives is sometimes referred to as a "free choice." However, when the two types of situations explained previously are excluded, this so-called free-choice area is extremely small.[21] For many choices, the auditor should have an objective basis for exercising his judgment in evaluating management's decision.

Direction for Evaluating Cumulative Effect

Accounting principles appropriate to individual circumstances may be selected and applied properly, yet the resulting financial statements as a whole may be biased or misleading.[22] Additional direction is needed to ensure that the auditor makes an evaluation of the cumulative effect of management's judgment in the presentation of financial statements. For example, the auditor may make many separate evaluations of the appropriateness of accounting principles selected and estimates made by management. On viewing the financial statements as a whole, the auditor may find that most or all of the selections or estimates made by management had the effect of increasing (or decreasing) earnings and that the overall result is a misleading picture of the entity's earning power or liquidity.

Present standards require the auditor to use judgment to see that the selection and application of particular accounting principles do not produce a misleading result.[23] He should exercise a similar judgment in evaluating the cumulative effect of the selection and application of accounting principles. This is the only position consistent with the views expressed by regulatory agencies and the courts that auditors have an obligation to go beyond determining technical compliance with specific accounting principles and to evaluate the overall presentation of earnings and financial position in the financial statements.

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21. For example, in a February 1974 letter to the SEC on Securities Act Release No. 33-5427, the AICPA's Accounting Standards Division commented that, except for specialized industries, only five areas existed in which circumstances did not affect the choice of accounting principles: (1) investment credit, (2) deferred research and development costs, preoperating costs, start-up costs and similar deferrals, (3) inventories, (4) depreciation, and (5) goodwill and other purchased or acquired intangibles. When subsequent pronouncements by the FASB are considered and the two types of situations previously explained excluded, the only remaining areas are start-up costs and similar deferrals and goodwill and other purchased or acquired intangibles.

22. John C. Burton, at the time the chief accountant of the SEC, suggested that financial statements should not "lead users to a forecast of other conclusions which preparers and auditors know to be unlikely or incorrect." (John C. Burton, "Fair Presentation: Another View," *The CPA Journal* 45 [June 1975]: 17.)

23. Rule 203 of the AICPA *Code of Professional Ethics* (AICPA, *Professional Standards,* vol. 2, ET section 203.01), and Statement on Auditing Standards No. 5, paragraph 9 (AICPA, *Professional Standards,* vol. 1, AU section 411.09).

3 Reporting on Significant Uncertainties in Financial Presentations

Uncertainty about the future can have an important effect on a company's financial position and earnings. Subsequent resolution of events that were uncertain when financial statements were issued can cause major changes in the evaluation of a company's earning power or solvency.

Present reporting requirements for uncertainties include a combination of accounting standards for the recording and disclosure of uncertainties and auditing standards on the form of auditor's report when significant uncertainties exist. Our consideration of the effects of present requirements has raised doubts about the adequacy of these requirements to inform financial statement users of the potential effects of significant uncertainties. It also causes us to question the appropriateness of the role imposed on the independent auditor by present audit reporting requirements for uncertainties.

PRESENT REPORTING REQUIREMENTS FOR UNCERTAINTIES

Financial statement amounts are always subject to varying degrees of imprecision. In a typical set of financial statements, cash in the balance sheet may be the only amount with a high degree of accuracy. The amounts presented for other assets, many liabilities, and most revenues and expenses are based on numerous estimates and judgments.

Uncertainties and Imprecision in Financial Statements

Uncertainty about the outcome of future events affects the measurement of both an entity's earnings for a particular period and the measurement of its assets and liabilities at a particular date. It is a major source of imprecision in financial statements. For example, assets normally include accounts receivable, for which an estimate of the amount that may be uncollectible is required. Liabilities sometimes include estimates of claims to be paid under warranties and similar obligations. Many matters that affect financial statements cannot be resolved until some future date. Lawsuits must await judicial determination or settlement, and assets in a foreign location may be jeopardized by political unrest or a threat of expropriation. The resolution of such uncertainties must await the outcome of future events, but financial statements are traditionally issued on a periodic basis, at least annually. Financial statement amounts often must be determined on the basis of the best estimates that management can make at the time. Unresolvable matters can only be explained in footnote disclosure.[1]

Effect of Uncertainties on the Auditor's Opinion

Under present reporting requirements an auditor qualifies his opinion on a company's financial statements when they are affected by a material uncertainty and when the effects of the outcome of the future event that will resolve the uncertainty cannot be reasonably

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1. The accounting standards for recording and disclosing uncertainties are set forth in Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (March 1975) (AICPA, *Professional Standards,* vol. 3, AC section 4311).

estimated.[2] For example, an opinion may be qualified pending the outcome of litigation, negotiation of a new lending agreement, or the future determination of the recoverability of investments.

When Armstrong Cork Company, for example, released its 1974 financial statements in early 1975, it was involved in litigation for alleged patent infringement. The independent auditor's opinion was qualified "subject to" the potential effect of the uncertainty on the financial statements, and a middle paragraph was added to the report to describe the uncertainty:

> ARMSTRONG CORK COMPANY
> Auditor's Report
>
> The Board of Directors and Stockholders,
> Armstrong Cork Company:
>
> We have examined the consolidated balance sheets of Armstrong Cork Company and subsidiaries as of December 31, 1974 and 1973 and the related consolidated statements of earnings and changes in financial position for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> The company is involved in continuing litigation relating to patent infringement. The amount of damages, if any, resulting from this litigation cannot be determined at this time. See Litigation . . . for further details.
>
> In our opinion, subject to the effect on the accompanying financial statements, if any, of the resolution of the matter referred to in the preceding paragraph, the aforementioned consolidated financial statements present fairly the financial position of Armstrong Cork Company and subsidiaries at December 31, 1974 and 1973 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles which, except for the changes in 1974, with which we concur, in the method of valuing inventories and the method of accounting for fluctuations in foreign exchange rates explained on pages 19 and 20 of the financial review, have been applied on a consistent basis.
>
> Peat, Marwick, Mitchell & Co.
>
> February 14, 1975

Armstrong Cork explained the litigation in the note to its financial statements referred to in the auditor's report:

> Notes to Financial Statements
>
> In February, 1975, the Court of Appeals for the Third Circuit affirmed the earlier decision of the United States District Court holding that the company infringed chemical embossing patents held by Congoleum Industries, Inc. The decision applies only to the company's United States manufacture of a certain type of rotovinyl floor-

2. Statement on Auditing Standards No. 2, *Reports on Audited Financial Statements* (October 1974), paragraphs 21–26 (AICPA, *Professional Standards,* vol. 1, AU section 509.21–.26). The meaning and use of qualified opinions are explained in SAS No. 2. Paragraph 29 states, "A qualified opinion states that, 'except for' or 'subject to' the effects of the matter to which the qualification relates, the financial statements present fairly . . . in conformity with generally accepted accounting principles. . . ." Paragraph 35 notes that "[if] the qualification arises because of an uncertainty affecting the financial statements; then the expression 'subject to' should be used."

ing during the period 1967 through 1972. A request for the review of this decision by the Supreme Court of the United States is now being actively pursued.

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

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

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

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

Deficiencies in Present Audit Requirements for Uncertainties

From the perspective of both users of financial statements and independent auditors, the present requirements for reporting on uncertainties are deficient.

Contradictory Audit Requirements. From the auditor's viewpoint, his present responsibility to include specific information on uncertainties in his report is inconsistent with his role in expressing an opinion on the presentation of other aspects of financial statements. The auditor normally evaluates whether financial information presented by management conforms with appropriate standards. In contrast, for uncertainties he is required to be a reporter and interpreter of financial information as well.

In other circumstances in which he qualifies his opinion, the exception is based on a disagreement between the auditor and management concerning the appropriateness of the accounting principles applied, a change in those principles, the adequacy of disclosure, or restrictions on the audit procedures that the auditor has been able to apply. Under present requirements, when a qualification is caused solely by an uncertainty, the auditor should be in agreement with management concerning the representations made in the financial statements.

Confusing to Users. The meaning and significance of a "subject to" qualification are difficult to understand. The "subject to" phrase is ambiguous to users because there is no way for them to tell whether the auditor's intention is only to highlight information more fully disclosed elsewhere or to indicate a deficiency in the financial statements. If a reasonable estimate cannot be made of the outcome of the uncertainty and the circumstances surrounding the uncertainty are adequately disclosed, the financial statements are not deficient. The "subject to" qualification may cause the financial statement user to believe the financial statements will be restated when the uncertainty is resolved, but this will probably not be the case.[3]

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3. The Financial Accounting Standards Board is currently considering an accounting standard that would virtually eliminate such restatements (*Prior Period Adjustments* [Exposure Draft], July 29, 1976).

In fact, the general practice of using "subject to" qualifications may confuse financial statement users. The standards for uncertainties that require qualification are inherently vague and not susceptible to a desirable degree of uniformity in practice. In evaluating whether to qualify an opinion, the auditor must consider the amount of the potential loss and the probability of occurrence of the future event that would confirm the loss.[4] For example, the damages claimed in litigation may be an exceedingly large amount, but if the probability of losing the litigation is minimal the auditor is not required to qualify his opinion and doing so would serve no useful purpose. Since the decision to qualify must be based on an evaluation of probability, the auditor's reporting decision becomes a prediction of the outcome of future events independent of management's evaluation. The combination of probability and amount involved in the decision whether to express a "subject to" qualification because of an uncertainty differs considerably from other materiality evaluations. Other decisions to qualify an opinion require a consideration only of the significance of known financial statement amounts or the relative importance of known information.

Creation of False Expectations. Since auditors are known to qualify their opinions for some material uncertainties, the absence of a qualification may lead financial statement users to believe a company faces no uncertainties that could materially affect its financial condition or operating results. All companies, however, face a variety of economic risks. Operating results may be materially affected by future changes in the national economy, actions of competitors, or other events that specifically and immediately affect the company. General business risks such as those resulting from inflation or changes in national laws and regulations are not normally disclosed. Other risks may be difficult or impossible to identify. For example, the beverage industry was seriously affected when products containing cyclamates were banned, but that type of event is extremely difficult to anticipate. A legal action that a potential plaintiff plans to bring may seriously affect future operations but may remain unknown to the company and its auditor until the plaintiff asserts a claim. Thus, an unqualified opinion does not mean that a company faces no significant uncertainties, but the practice of qualifying opinions for some uncertainties may foster that erroneous belief.

THE NEED TO CLARIFY THE AUDITOR'S ROLE IN REPORTING ON UNCERTAINTIES

A company's financial statements should adequately disclose the uncertainties it faces and their possible effect on its earnings and financial position. An investor or creditor incurs the risk that the financial information does not contain adequate disclosure as well as the risk the company faces in doing business. The auditor cannot change the risk of doing business or guarantee the commercial success of his clients. Evaluating the risks a

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4. The type of probability evaluation for uncertainties differs from the traditional notion of statistical probability. It is a subjective evaluation. Statement of Financial Accounting Standards No. 5, paragraph 3 (AICPA, *Professional Standards,* vol. 3, AC section 4311.03), notes that the likelihood of a future event can range from probable to remote and defines areas within that range as follows:

> *Probable.* The future event or events are likely to occur.
>
> *Reasonably possible.* The chance of the future event occurring is more than remote but less than likely.
>
> *Remote.* The chance of the future event or events occurring is slight.

Thus, the probability evaluation required by accounting standards is far less than precise. Requiring the auditor to make an additional evaluation of probability only adds to that imprecision.

business faces is a function that must be assumed by the user of the financial statements. Evaluating the adequacy of the disclosure of risks that affect the financial statements is the auditor's responsibility; he should provide protection against information risk. The present audit requirements for uncertainties blur the distinction between the two types of risk and invite confusion as to the auditor's responsibility.

The Needs of Users for Adequate Information to Evaluate Uncertainties

Financial statement users need information adequate to permit the evaluation of the significance of an uncertainty and the likely consequences of its resolution.

In *Herzfeld* v. *Laventhol Krekstein Horwath & Horwath*[5] the auditors expressed a "subject to" qualification because of the uncertainty of collecting a receivable resulting from the purchase and immediate resale of real estate. The uncertainty concerned the subsequent purchaser's ability to make the payments called for in the contract of sale. The court emphasized that "each investor was entitled to decide for *himself,* on the basis of the stark facts, whether the transaction [the purchase and subsequent sale of real estate] had a realistic prospect of being completed." An appellate court, commenting on the failure to disclose a potential antitrust action in the case of *Gulf & Western* v. *Great Atlantic and Pacific Tea Company,*[6] stated that "the disclosure requirements of the securities laws require 'nothing more than a disclosure of basic facts so that outsiders may draw upon their own evaluative experience in reaching their own investment decisions with knowledge equal to that of the insiders.' "

The SEC in Accounting Series Release No. 173 criticized an auditor's "subject to" qualified opinion on the financial statements of Talley Industries, in part, because the facts disclosed concerning the uncertainty were insufficient.[7] The SEC's analysis emphasized the difficulty and subjectivity of the prediction reflected in financial statement amounts for cost of sales, and it indicated that the auditor's opinion and the footnote disclosure of the uncertainty did not provide sufficient information to users.

The report of the Study Group on the Objectives of Financial Statements also expressed the view that "users generally will want to make their own judgments about uncertainties," and it suggested several ways that financial statements could be improved to enable users to better identify and evaluate uncertainties.[8]

The Auditor's Inability to Predict the Outcome of Many Uncertainties

Financial statement users should be provided with enough information to assess the risks a business faces and make their own evaluation of the potential future gain or loss. However, the auditor frequently is in no better position than the average user of financial statements to predict the ultimate resolution of many uncertainties. A lawsuit awaiting judicial determination, the possibility of sales of a new product, the ability to obtain additional financing, or the likelihood of passage of unfavorable tax legislation under consideration are examples of matters that the auditor is no better equipped to evaluate than are fully informed financial statement users.

5. Herzfeld v. Laventhol Krekstein Horwath & Horwath, U.S.D.C., S.D.N.Y., No. 71, Civ. 2209 (LFM), May 29, 1974 (CCH Fed. Sec. L. Reptr. 94,574).

6. Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co., Inc., 476 F.2d 687, 697 (2d Cir., 1973) (CCH Fed. Sec. L. Reptr. 93,814).

7. SEC Accounting Series Release No. 173, "In the Matter of Peat, Marwick, Mitchell & Co.," July 2, 1975. The SEC also suggested that, in the circumstances, the accounting method used to allocate program costs between cost of sales and inventories was inappropriate.

8. Study Group on the Objectives of Financial Statements, *Objectives of Financial Statements* (New York: AICPA, 1973), p. 33.

Based on his specialized experience, the auditor may be in a better position to evaluate the outcome of some uncertainties such as the likely settlement based on interpretation of a disputed tax regulation or the cost to be allowed under a government contract. In such circumstances, the auditor may disagree with management's evaluation of the uncertainty; in others, the auditor may believe the information disclosed does not adequately reflect the considerations bearing on the potential outcome. In these two circumstances, the auditor should require the statements to be adjusted or the disclosure to be made. If management does not make the required adjustments or disclosures, the auditor must express a qualified or an adverse opinion because of a departure from generally accepted accounting principles. Thus, in those few circumstances in which the auditor is in a better position than the average user to evaluate the outcome of an uncertainty, his proper response is something other than a "subject to" qualification.

The Qualified Opinion and Protection for Auditors

If a material uncertainty is resolved unfavorably, the company's resources may be seriously depleted, and investors and creditors may incur losses. Often, the auditor is the only individual with any remaining resources, and he becomes the target of a lawsuit by investors or creditors.

Some auditors believe that compliance with present requirements for qualifying an opinion because of an uncertainty provides desirable legal protection. There is evidence, however, that auditors may derive little or no protection from "subject to" qualifications. In a directly pertinent case *(Herzfeld)* and in a regulatory proceeding (Talley Industries in ASR No. 173), the auditors' "subject to" qualifications provided no protection. The real issue was whether enough information was provided to allow a financial statement user to make his own assessment of the probable outcome of the uncertainty. In other cases involving limitations on the scope of the auditor's examination,[9] the courts considered only the information provided to the financial statement user and not the modification of the auditor's opinion.

RECOMMENDATIONS FOR IMPROVING REPORTING ON UNCERTAINTIES

Changes are needed in both the audit reporting requirements and the financial accounting standards for uncertainties.

Recommended Changes in Audit Requirements

A major part of the auditor's present role is to evaluate whether the information presented by the company adequately portrays its financial position and earnings and the related uncertainties surrounding their measurement. That responsibility should be retained. The auditor should not attempt to reduce uncertainty by predicting the outcome of future events. However, under current requirements, some prediction is inevitably involved in deciding whether to express a "subject to" qualification. The auditor should be expected to evaluate the information presented and decide whether financial statement users are given enough information to make their own evaluation of the outcome of uncertainties. The present audit reporting requirements for uncertainties are inconsistent with the auditor's accepted role in expressing an opinion; they may confuse users; and they may create false expectations. Also, a "subject to" qualification provides little or no protection for an independent auditor.

9. Stephens Industries, Inc. v. Haskins & Sells, 438 F.2d 357 (10th Cir., 1971) [Finding for the defendant because of adequate disclosure of scope limitation]. Rhode Island Hospital Trust National Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847 (4th Cir., 1972) [Finding for the plaintiff because of inadequate disclosure of scope limitation].

The need to consider whether to qualify may cause the auditor to devote too little attention to evaluating the adequacy of disclosure of uncertainties. Users of financial statements need enough information to make their own evaluation of uncertainties, and they are not served by a reporting requirement that diverts the auditor's attention from evaluating the disclosure of uncertainties to highlighting the existence of some uncertainties.

For the foregoing reasons, the audit requirement to express a "subject to" qualification when financial statements are affected by material uncertainties should be eliminated. In combination with improvements in financial accounting standards for the disclosure of uncertainties, eliminating the requirement should improve understanding of both the effect of uncertainties on financial statements and the auditor's responsibility when uncertainties exist.

Recommended Changes in Financial Accounting Standards

The present requirements for disclosure and presentation of uncertainties should be modified. Users should be better informed about the uncertainties involved in the preparation of financial statements, and the information required to be disclosed should be expanded to improve the ability of users to identify and evaluate significant uncertainties.

A separate note, similar to that on accounting policies, should be required for uncertainties.[10] It should explain the significance of the information for future operations. A standardized position and heading for the note would contribute to user understanding.

The note should include for each material uncertainty information required by Statement of Financial Accounting Standards No. 5, such as a description of the circumstances surrounding the uncertainty, management's assumptions about the outcome of the uncertainty, an explanation of the range of possible outcomes and their potential effects, and any other considerations that bear on the probable outcome of the identifiable future event involved.

Such a note should identify material uncertainties for financial statement users, the purpose now sought to be accomplished by qualification of the auditor's opinion. The note should not, however, be limited to uncertainties that might have resulted in a "subject to" qualification. No uncertainty for which disclosure is required should be downgraded in importance. Disclosure requirements should be oriented to providing users with enough information to make their own evaluation of uncertainties and the potential effect on future operations.

The Implications of the Recommended Changes for Reporting "Going-Concern" Uncertainties

One of the most significant uncertainties that can cause a "subject to" qualification under present reporting requirements is doubt about a company's ability to continue operations. When this occurs, the recoverability and classification of most asset amounts and the amounts and classification of many liabilities are called into question. In these circumstances, financial statements based on the assumption of liquidation may more adequately portray the company's financial position.

The conditions that cause doubt about a company's ability to continue operations usually include some combination of recurring operating losses, serious deficiencies in working capital, inability to comply with the terms of loan agreements, or difficulty in obtaining sufficient financing. A single lawsuit may be sufficient to cause a going-concern uncertainty if an unfavorable outcome would jeopardize continued operations.

A distinguishing feature of a going-concern uncertainty is the extreme consequence

10. Accounting Principles Board Opinion No. 22, *Disclosure of Accounting Policies* (April 1972) (AICPA, *Professional Standards,* vol. 3, AC section 2045).

of *unfavorable resolution. The implications of eliminating the audit requirements* to express a "subject to" qualification when significant uncertainties exist are highlighted by consideration of going-concern uncertainties.

There is no reason to believe independent auditors are more able to predict whether a company will liquidate than they are able to predict the outcome of other uncertainties. In fact, research has shown that an analysis of financial statements, using certain simple financial ratios, is a better indicator of a company's future prospects than noting whether the auditor had expressed a qualified opinion or an unqualified opinion.[11]

A qualified opinion expressing doubts concerning a company's ability to continue as a going concern is not intended to be a prediction of liquidation, but many financial statement users apparently view it as such. Creditors often regard a "subject to" qualification as a separate reason for not granting a loan, a reason in addition to the circumstances creating the uncertainty that caused the qualification. This frequently puts the auditor in the position of, in effect, deciding whether a company is able to obtain the funds it needs to continue operating. Thus, the auditor's qualification tends to be a self-fulfilling prophecy: The auditor's expression of uncertainty about the company's ability to continue may make the company's inability a certainty.

An unqualified opinion is not a guarantee that a company will continue operations, but the general practice of giving "subject to" qualifications for going-concern uncertainties may create that impression. If uncertainty about a company's ability to continue operations is adequately disclosed in its financial statements, the auditor should not be required to call attention to that uncertainty in his report.

Considerable improvement is no doubt required in the disclosure of going-concern uncertainties, and many innovations in disclosure may be necessary. Often the uncertainty is caused by a series of related factors, and separate presentation of those factors is not sufficient. The relationship among uncertain matters should be disclosed and their implications for the company's ability to continue operations explained. Information on the effect of unfavorable resolution may require supplemental presentation of estimates of liquidation value if the amounts are materially different from those in the financial statements. If the auditor does not believe disclosure is sufficient to portray the company's financial position, he should express an adverse opinion because the financial statements do not fairly present the company's financial position in conformity with generally accepted accounting principles.[12]

Thus, even the extreme uncertainty about a company's ability to continue operations can be more effectively communicated by disclosure in or adjustment of financial statements than by audit reporting requirements.

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11. Edward I. Altman and Thomas P. McGough, "Evaluation of a Company as a Going Concern," *The Journal of Accountancy* (December 1974): 50–57. "Survey of Resolution of Uncertainties Disclosed in Annual Reports," a research project to test the general applicability of Altman and McGough's findings to other types of uncertainties, is described in appendix B.

12. Statements on Auditing Standards No. 2, paragraph 41 (AICPA, *Professional Standards,* vol. 1, AU section 509.41), explains that an adverse opinion "is expressed when, in the auditor's judgment . . ., the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles."

4 Clarifying Responsibility for the Detection of Fraud

Fraud is an ever-present threat to business corporations and other entities in society. Management, operating outside the controls over the accounting system, may either misappropriate or misuse assets or intentionally mislead financial statement users. Assets may be misappropriated or misused by nonmanagement employees who circumvent the controls over the accounting system.

No major aspect of the independent auditor's role has caused more difficulty for the auditor than questions about his responsibility for the detection of fraud. In the last ten years, a number of major frauds that independent auditors failed to detect have focused unfavorable attention on this aspect of the audit function.

THE EXPECTATIONS OF USERS

Independent auditors have always acknowledged some responsibility to consider the existence of fraud in conducting an audit. Nevertheless, the nature and extent of that responsibility are unclear. Court decisions, criticisms by the financial press, actions by regulatory bodies, and surveys of users indicate dissatisfaction with the responsibility for fraud detection acknowledged by auditors.[1]

Opinion surveys in this and other countries indicate that concerned segments of the public expect independent auditors to assume greater responsibility in this area. Significant percentages of those who use and rely on the auditor's work rank the detection of fraud among the most important objectives of an audit.[2]

The SEC has consistently taken the position that the detection of fraud is an important objective of an audit. In Accounting Series Release No. 19, "In the Matter of McKesson & Robbins, Inc.," issued in 1940, the Commission stated,

> Moreover, we believe that, even in balance sheet examinations for corporations whose securities are held by the public, accountants can be expected to detect gross overstatements of assets and profits whether resulting from collusive fraud or otherwise. We believe that alertness on the part of the entire [audit] staff, coupled with intelligent analysis by experienced accountants of the manner of doing business, should detect overstatements in the accounts, regardless of their cause, long before they asume the magnitude reached in this case. Furthermore, an examination of this kind should not, in our opinion, exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted. Without

1. Descriptions of the auditor's responsibility in authoritative literature have led to conflicting interpretations. The AICPA's special committee on Equity Funding concluded that the present description in the official literature of the auditor's responsibility for the detection of fraud, with its greater emphasis on the limitations rather than on the positive aspects of the matter, "may contribute to the risk of disparity in understanding, between the public at large and the public accounting profession, as to what an auditor's responsibility is with respect to the detection of fraud." *(Report of the Special Committee on Equity Funding* [New York: AICPA, 1975], p. 40).

2. A survey conducted for Arthur Andersen & Co. indicated that 66 percent of the investing public believes that "the most important function of the public accounting firm's audit of a corporation is to detect fraud." (Opinion Research Corporation, *Public Accounting in Transition* [Chicago: Arthur Andersen & Co., 1974], p. 48.) See also G. W. Beck, *Public Accountants in Australia: Their Social Role* (Ph.D. diss., University of Queensland, Brisbane, Australia, 1972), and T. A. Lee, "The Nature of Auditing and Its Objectives," *Accountancy* (England) 81 (April 1970): 292–96.

underestimating the important service rendered by independent public accountants in their review of the accounting principles employed in the preparation of financial statements filed with us and issued to stockholders, we feel that the discovery of gross overstatements in the accounts is a major purpose of such an audit even though it be conceded that it might not disclose every minor defalcation.

This position was reiterated in 1974 in exactly the same terms in ASR No. 153.[3]

The courts have also shown a readiness to hold auditors responsible for material misrepresentations in financial statements and have recognized that failure to detect fraud can indicate a failure to exercise the standard of care society expects of independent auditors.[4]

The viewpoint of various groups of users, the SEC, and the courts was expressed well in an article in *Accountancy* on the role of the independent auditor: "The first object of an audit is to say that the accounts can be *relied on,* that they are 'all right'; it is absurd to say that they are all right subject of course to the possibility that undetected fraud may have made them all wrong."[5]

THE CONCEPT OF FRAUD AND THE AUDITOR'S EVOLVING APPROACH TO ITS DETECTION

Viewed broadly, any intentional act designed to deceive or mislead others is fraud. Fraud in the business environment with which the auditor is concerned has a more specialized meaning.

Fraud From the Auditor's Viewpoint

Fraud may occur at the employee or management level. Frauds by nonmanagement employees are generally designed to convert cash or other assets to an employee's own benefit. Management fraud may differ significantly. Often direct theft is not involved. It may be a "performance fraud"—the use of deceptive practices to inflate earnings or to forestall the recognition of either insolvency or a decline in earnings.

The auditor's concern about the possibility of fraud relates primarily to intentional misrepresentations in or omissions from financial statements. These misrepresentations are undertaken by management to mislead users, but at the same time necessitate actions to mislead the auditor. The auditor is also concerned with misappropriations or misuse of assets and other irregularities that constitute fraud.

Fraud at the management level includes intentional misrepresentations that may lead to improper selection of accounting principles or inclusion of false amounts in, or the omission of amounts from, financial statements. It is usually accompanied by acts of concealment, such as omission of entries, manipulation of documents (including forgery), or collusion among individuals inside or outside the company. It may take several forms, including

3. SEC Accounting Series Release No. 153, "In the Matter of Touche Ross & Co.," February 25, 1974.

4. For example, see the discussion of an Australian court's decision on the auditor's responsibilities with regard to fraud in W. J. Kenley, "Legal Decisions Affecting Auditors: Comments on the Pacific Acceptance Corporation Case," *The Australian Accountant* 41 (May 1971): 153–61. Our staff analyses (described in appendix B) include cases in which auditors were held responsible for failure to detect material fraud. Also, the Commission's consideration of the legal environment of independent auditors demonstrates that such failures in audit performance subject the auditor to liability to an expanding group of users.

5. A.M.C. Morison, "The Role of the Reporting Accountant Today—II," *Accountancy* (England) 82 (March 1971): 120–30.

- *Fictitious transactions*—nonexistent transactions recorded to overstate revenue or assets. For example, the Equity Funding fraud involved recording fictitious loans receivable and issuing bogus insurance policies.
- *Transactions without substance*—transactions arranged by management with related parties (with the relationship not adequately disclosed) so that substantial undisclosed risks are retained by the company. ASR No. 153 (1974), for example, describes several real estate transactions of U.S. Financial, Inc., alleged to have been fashioned by management to make it appear that income had been earned when in fact it had not.
- *Intentional misapplication of accounting methods to actual transactions to produce misleading results*—income measurement methods, such as realization or the assignment of transactions to periods, misapplied to recognize revenue without evidence of realization, to misclassify assets, liabilities, revenue, or expenses, or to record transactions in the wrong period. For example, the practices alleged to have been followed by Stirling Homex (as described in ASR No. 173)[6] in recognizing sales of modular dwelling units illustrate alleged management misrepresentations to the auditor of the circumstances of transactions and the validity of relevant documents to support recognition of income.

Management fraud does not include matters that involve management's legitimate discretion in the selection and application of generally accepted accounting principles, including appropriate disclosure, when the independent auditor knows the relevant facts and concurs with management's judgment. However, the distinction between intentional misapplication of accounting principles and management's appropriate exercise of discretion is complex and may often be resolved only through litigation. As a result of litigation, errors in judgment or mistakes in applying accounting principles have sometimes been found to involve constructive fraud. If the independent auditor knows the relevant facts, however, questions that might then arise concern his responsibility for judging the appropriateness of accounting principles, not his responsibility to detect fraud.

The Evolution of an Unclear Description of the Auditor's Responsibility

The auditor's concern with detecting fraud was clearly expressed in works such as Dicksee's *Auditing,* first published in the nineteenth century, when the threefold object of an audit was said to be the detection of fraud, the detection of technical errors, and the detection of errors of principle.[7]

Erosion of Responsibility for Fraud Detection. The straightforward recognition, in early literature, of the detection of fraud as an object of an audit has been steadily eroded. This erosion is evident in the descriptions of responsibility in successive editions of Montgomery's *Auditing*[8] and in professional standards. In the first three editions (1912, 1916, and 1923), Montgomery acknowledged that in the formative days of auditing "students were

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6. SEC Accounting Series Release No. 173, "In the Matter of Peat, Marwick, Mitchell & Co.," July 2, 1975.

7. Lawrence R. Dicksee, *Auditing: A Practical Manual for Auditors,* 3d ed., rev. and enl. (London: Gee & Co., 1898), p. 8.

8. Robert H. Montgomery, *Auditing, Theory and Practice* (New York: The Ronald Press, 1912, 1916, 1923, and 1957). Obviously, many other sources could have been used to document the erosion. However, the several editions of this book comprised the most significant series of auditing texts in the United States for many years. They provide a continuous source, widely regarded by accountants as highly authoritative, particularly in the period before official bodies issued formal pronouncements.

taught" that "the detection or prevention of fraud" and "the detection or prevention of errors" were the "chief objects" of an audit. He went on to explain that the former "chief objects" must be relegated to a subordinate position because those who retain auditors "have enlarged their demands and now require a vastly broader and more important class of work." Subsequent editions gave less and less emphasis to the detection of fraud until, in the eighth edition (1957), it was described as a "responsibility not assumed," with the observation that, "The American Institute has properly pointed out that if an auditor were to attempt to discover defalcations and similar irregularities he would have to extend his work to a point where its cost would be prohibitive."

In Montgomery, this disavowal of responsibility clearly relates to the detection of "defalcations and similar irregularities" (misappropriation or misuse of assets with no material effect on financial statements); Montgomery's position on the detection of management fraud is not clear.

From the beginning, auditing pronouncements have tended to emphasize the limitations on the auditor's responsibility for the detection of fraud rather than the positive aspects. *Verification of Financial Statements,* a booklet on auditing procedures prepared by the American Institute of [Certified Public] Accountants and published in 1929 under the auspices of the Federal Reserve Board, stated that the recommended procedures "will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions or by manipulation of the accounts."[9]

In 1933, a letter from the New York Stock Exchange's Committee on Stock List to its Governing Committee recognized and accepted the limitation in *Verification of Financial Statements.*

> Your committee is satisfied that the detailed scrutiny and verification of the cash transactions of large companies can most efficiently and economically be performed by permanent employees of the corporation . . . and that it would involve unwarranted expense to transfer such work to independent auditors or to require them to duplicate the work of the internal organization. Your committee, however, feels that the auditors should assume a definite responsibility for satisfying themselves that the system of internal check provides adequate safeguards and should protect the company against any defalcation of major importance.

The letter goes on to discuss other responsibilities that the auditor should assume.

> . . . The auditor should recognize a responsibility to verify and, if necessary, to report to the shareholders upon any transactions affecting directors or officers of the corporation in respect of which there might be a conflict of interest between such directors and officers and the general body of shareholders.[10]

Thus, the independent auditor was expected to be concerned with management's accountability for corporate assets and to guard against the possibility of material misrepresentations in financial statements caused by fraud. Auditors were not expected to be concerned with the possibility of immaterial frauds that would not significantly distort financial statements or that would not result in a major loss of assets.

Subsequent pronouncements, however, placed primary emphasis on the lack of responsibility for immaterial frauds, such as defalcations. These pronouncements contributed significantly to an evolving attitude among auditors of minimal responsibility for

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9. Federal Reserve Board, *Verification of Financial Statements,* 1929, also published in The *Journal of Accountancy* (May 1929): 321–54.

10. *Audits of Corporate Accounts* (New York: American Institute of [Certified Public] Accountants, 1934; reprint ed., 1963), p. 19.

detection of fraud. The position of the American Institute of [Certified Public] Accountants in Statement on Auditing Procedure No. 1, *Extensions of Auditing Procedure,* issued in 1939, emphasized "defalcations and other similar irregularities" and stressed the limitations on the auditor. The position slightly modified was carried forward in a codification of auditing pronouncements issued in 1951.

> The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed *and cannot be relied upon* to disclose defalcations and other similar irregularities, although their discovery frequently results. In a well-organized concern reliance for the detection of such irregularities is placed principally upon the maintenance of an adequate system of accounting records with appropriate internal control. If an auditor were to attempt to discover defalcations and similar irregularities he would have to extend his work to a point where its cost would be prohibitive. It is generally recognized that good internal control and surety bonds provide protection much more cheaply. On the basis of his examination by tests and checks, made in the light of his review and tests of the system of internal control, the auditor relies upon the integrity of the client's organization unless circumstances are such as to arouse his suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.[11]

This position seemed to many readers to disavow all but an incidental responsibility for fraud detection, even though the disavowal concerned "defalcations and other similar irregularities." It remained in the official literature for over twenty years and played an important part in shaping the attitude of auditors.

Slight Improvement in Recognition of Responsibility. By 1960, however, the negative and defensive tone of the official position on fraud detection was no longer acceptable to the profession, and the description of responsibility was amended to read in part as follows:

> In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentation by management, or both. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards.[12]

Many in the profession felt this position put the auditor's responsibility for the detection of fraud, particularly management fraud, in proper perspective. It was not limited to "defalcations and other similar irregularities." A greater responsibility for management fraud was

11. *Codification of Statements on Auditing Procedure* (New York: American Institute of [Certified Public] Accountants, 1951), pp. 12–13.

12. Statement on Auditing Standards No. 1 (November 1972), section 110.05 (AICPA, *Professional Standards,* vol. 1, AU section 110.05). Originally issued as Statement on Auditing Procedure No. 30, September 1960.

acknowledged, but the nature and extent of that responsibility were still unclear to some and were hedged by negative language.

Recognition of Responsibility in Present Standards for the Detection of Management Fraud

The American Institute of Certified Public Accountants has recently taken positive actions to clarify and strengthen auditing standards related to responsibility for detection of fraud. For example, Statement on Auditing Standards No. 6 on related party transactions, issued in July 1975, requires the auditor to search for transactions with related parties and to probe the details of material transactions to determine whether management is involved. Statement on Auditing Standards No. 16, on the detection of errors and irregularities, clarifies existing guidance for directing an auditor's attention to possible management fraud. It represents a significant advance in the profession's position on responsibility for detection of fraud.

Nevertheless, we believe that position could and should be further improved by elaboration along the following lines.[13]

A SUGGESTED EXPLANATION OF THE AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF FRAUD

The essential basis for an explicit statement on the independent auditor's responsibility for the detection of fraud is that users of financial statements should have the right to assume that audited financial information is not unreliable because of fraud and that management maintains appropriate controls to safeguard assets. An audit should be designed to provide reasonable assurance that the financial statements are not affected by material fraud and also to provide reasonable assurance on the accountability of management for material amounts of corporate assets.[14]

In an audit of financial statements, an independent auditor is concerned with the adequacy of controls and other measures designed to prevent fraud, has a duty to search for fraud, and should be expected to detect those frauds that the exercise of professional skill and care would normally uncover.

This description of the auditor's responsibility includes the responsibility to see that the financial statements report and explain adequately the nature and effects of material frauds discovered. It is a general description of responsibility, however, and, standing alone, it does not provide adequate guidance for independent auditors nor an adequate standard by which their performance may be judged by others. Explicit guidance on the appropriate exercise of professional skill and care is necessary.

The concept of "due professional care" is part of generally accepted auditing standards.[15] That standard provides only a broad guide for judging performance. Nevertheless, it can form the basis for an elaboration of the elements of skill and care that should govern the performance of auditors.

In *The Philosophy of Auditing,* Mautz and Sharaf propose the development of

> a concept of professional care which indicates in more or less specific terms the

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13. An underlying problem of existing guidance is reflected in the extensive use of euphemisms to avoid the word *fraud.* A more forthright acknowledgement of responsibility is required.

14. Other aspects of the auditor's concern with management's accountability for corporate assets are considered in section 5.

15. The third general standard is, "Due professional care is to be exercised in the performance of the examination and the preparation of the report" (Statement on Auditing Standards No. 1, section 150.02 [AICPA, *Professional Standards,* vol. 1, AU section 150.02]).

considerations which must govern the performance of an examination by an auditor. If his examination is conducted with the care required by this concept he will discover certain types of irregularities, should they be present. Thus he is neither excused from discovering any and all irregularities nor charged with an examination so extensive that it will uncover any and all irregularities. Practitioners are expected, under this concept, to make a reasonable search for irregularities, to provide their clients and business generally with an important service and some effective protection; they are not held for an examination unreasonably extensive or rigorous. At the same time, the concept gives some useful guidance as to the extent of the search they should make.

Of course the statement of such a concept has implications for those outside the profession as well. To the extent that laymen understand the concept they have a satisfactory standard by which to establish their expectations and to measure the results of audit work. The general usefulness of such a concept should be apparent. Even more apparent should be the conclusion that formulation of such a concept is an appropriate, even an essential undertaking for a profession, to state fairly and clearly the responsibility which its members accept without equivocation or understatement.[16]

An auditor cannot be expected to detect all frauds. He cannot detect certain types of fraud, such as collusion between management and other parties whom he has no reason to suspect of duplicity. The need to provide audits at a rational cost imposes limits. Society does not require perfect performance of any professional. Thus, a standard of professional skill and care is needed to evaluate the performance of auditors.[17]

RECOMMENDATIONS ON A STANDARD OF CARE FOR FRAUD DETECTION

The recommendations in this section are intended to add to the substance of the standard of care for fraud detection and improve the effectiveness of independent auditors in performing this important aspect of the audit function. Several changes are necessary in professional standards, auditing practice, and support activities of the AICPA and public accounting firms to achieve these ends.

Many of the recommendations are not original. Some public accounting firms already apply a number of the recommended practices. Several of the subjects of the recommendations have been placed on the agenda of the AICPA's Auditing Standards Executive Committee. But while many of these recommendations may not be new, the emphasis on directing the auditor's attention to an active and affirmative responsibility for the detection of material fraud is a significant departure from the prevailing attitude of many independent auditors.

Establish an Effective Client Investigation Program

The relationship between an independent auditor and his clients makes it essential that the auditor exercise care in deciding to accept new clients and to retain clients. A systematic approach to investigating a prospective client before accepting a new engagement and a periodic review of continuing engagements are essential tools of independent

16. R.K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing* (Sarasota, Fla.: American Accounting Association, 1961), p. 131.

17. Statement on Auditing Standards No. 16, *The Independent Auditor's Responsibility for the Detection of Errors and Irregularities* (January 1977) (AICPA, *Professional Standards,* vol. 1, AU section 327), explains several factors that make the detection of some frauds impossible.

auditors. The reputation and integrity of a company and its management are critical factors in determining whether a company is auditable.

As noted above, an untrustworthy management may make it impossible to perform an audit. Elsewhere in this report the Commission considers the position of the auditor when internal controls may be so deficient as to preclude an audit. Consideration of these and other factors has led the Commission to the conclusion that controls may be so deficient that a company is not entitled to expect an auditor to express his opinion on its statements. Similarly, an auditor is under no obligation to accept or retain a client about whose integrity he has reservations; indeed, such clients should be rejected.

Take Immediate Steps if Evidence Shows That Management Is Untrustworthy

The exercise of professional skill and care requires healthy skepticism—a disposition to question and test the validity of all material management representations. The independent auditor should approach an examination with an open mind about the integrity and good faith of management. He should neither assume that management is dishonest nor take management's integrity and good faith for granted. The auditor's tests of the validity of transactions and resulting financial statement amounts or other evidence may cause him to question management's honesty or good faith.

The Commission's review of significant cases involving auditors and of other evidence makes it amply clear that when management is untrustworthy, there is a significant chance that a valid independent audit cannot be performed.[18] A dishonest management group that is determined and innovative has the ability, under the right circumstances, to perpetrate fraud and avoid detection by an auditor for a significant period of time.

Thus, if at any point serious doubts arise concerning the honesty, integrity, or good faith of management that cannot be satisfactorily resolved, the auditor should consider abandoning his attempt to audit; that is, he should consider resignation or other appropriate responses. Doubts about management integrity cannot be "satisfactorily resolved" merely by the extension of normal audit tests. Resolution of doubts means that the auditor should satisfy himself that his doubts about management were unfounded.

Observe Conditions Suggesting Predisposition to Management Frauds

In planning and conducting his examination, the auditor should take into account unusual circumstances or relationships that may predispose management to commit frauds. While it is impossible to catalog such conditions completely, some of the more obvious situations can be identified. For example, the auditor might find that a company is operating under economic conditions that motivate management to misrepresent earning power or solvency. He may find, among other things, that the industry is declining or experiencing a large number of business failures, the company lacks sufficient working capital or credit to continue operations, or is expanding at a rapid rate through new business or product lines, that the industry is overbuilt or its market is otherwise saturated, the company urgently needs a favorable earnings record to support the price of its stock, or is subject to restrictive covenants in bank or indenture agreements, or depends on a single or relatively few products, customers, or transactions for continued success.[19]

The auditor should be alert for these and similar conditions. On observing them, he should give due consideration in the audit to their existence—including a judgment as to the necessity for extending his audit procedures, or other appropriate measures.

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18. The staff analyses of cases involving alleged audit failures are described in appendix B.

19. SAS No. 16 on errors and irregularities identifies similar and other conditions that may increase the auditor's concern about the existence of fraud.

Maintain an Understanding of a Client's Business and Industry

Independent auditors recognize that an understanding of a client's business and the industry of which it is a part is critical to a proper audit. The required knowledge encompasses economic conditions, inherent internal control problems, and peculiarities of the industry. Although virtually all auditors would agree that having knowledge of a company and its industry is a necessary condition for a proper audit, that responsibility is not explicitly recognized in professional standards. Current professional standards provide the auditor little guidance on how to fulfill that responsibility. Consequently, the standard of professional skill and care should be sharpened to require specifically that the auditor have an understanding of the nature of the business of the company under examination, its methods of operations, and significant practices and regulatory requirements peculiar to the company or the industry of which it is a part.

Awareness of specific financial and business-related risks of an entity is essential to the application of informed judgment necessary for a proper audit. Thus, independent auditors should make every effort to acquire all readily available knowledge that might lead to perception of substantial financial or business-related risks deliberately or unwittingly accepted by the company under examination.

Extend the Study and Evaluation of Internal Control

The study and evaluation of internal control is an important aspect of an audit.[20] However, under present generally accepted auditing standards, it is performed solely to determine the extent of other procedures that the auditor must perform. The standard of professional skill and care should be amplified to require a study and evaluation of internal control beyond that now required. The auditor should be concerned with all controls that have a significant bearing on the prevention and detection of fraud. He should report material weaknesses to the proper level of management, including, if appropriate, the audit committee or the full board, and should follow up in the next year to determine whether the weaknesses have been eliminated.[21]

It would be unrealistic to insist that management accept all suggestions of the auditor for improvements in the internal control system. However, the auditor should determine that management has considered and responded adequately to suggestions for improvement in the internal control system.

Develop and Disseminate Information on Frauds and Methods of Detecting Fraud

A prudent auditor will seek knowledge of methods of perpetrating, concealing, and detecting fraud. Conditions indicating fraud and the methods of perpetrating fraud are not always obvious and change as the business environment changes. Auditors should recognize those changing conditions and be knowledgeable about the latest methods of perpetration and detection.

Methods and procedures should be adopted for public accounting firms to exchange information on developments in the perpetration and detection of fraud. The AICPA should establish means for regular dissemination of that type of information. For example,

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20. The second standard of field work included in the ten generally accepted auditing standards states, "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted" (Statement on Auditing Standards No. 1, section 320.01 [AICPA, *Professional Standards,* vol. 1, AU section 320.01]).

21. The question of the auditor's responsibility for reporting on internal control is explored in section 6.

the initiative shown by the AICPA in studying and reporting on the Equity Funding case should become the norm rather than the exception.[22]

Be Aware of Possible Deficiencies in Individual Audit Techniques and Steps

The Commission's review of significant cases involving auditors disclosed several instances in which certain traditional audit steps did not produce the assurances they were intended to provide. For example, direct confirmation with parties outside the company is an important method of substantiation of both financial statement amounts and other management representations. However, in several cases, outsiders either ignored incorrect information that was clearly shown in confirmations or actively cooperated with management in giving incorrect confirmation.

The point is not to suggest the elimination of confirmations in audits, but rather to emphasize that no audit test alone can be relied on to provide complete assurance of validity. In particular, recent events suggest that recipients accord less attention and effort to confirmation requests received. Constant attention should be given by both auditors and the AICPA to the effectiveness of conventional auditing techniques and to the development of new ones.

Understand the Limitations of Incomplete Audits

Auditors frequently undertake special, limited engagements at the request of clients. Such engagements are desirable. Auditors should have the ability to offer services tailored to the needs of clients. While an audit does contain a variety of interrelated steps and tests, which *will* often disclose frauds, limited engagements, directed only toward specific steps or evidence, provide far less assurance of fraud detection.[23]

Both auditors and clients should be fully aware of the limitations of the engagement. Auditors, in particular, should beware of undertaking special engagements that contain an element of fraud detection, without assuring full understanding, by themselves and their clients, of the inherent limitations of such engagements.

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22. The nature of the effort that should be undertaken in studying and reporting on suspected cases of audit failure is discussed further in section 11.

23. For example, the auditor of one reinsurance customer of Equity Funding was requested only to examine support for a limited number of policies. Testimony indicated that the client intended this special examination (at least in part) to detect fraudulent policies. Needless to say, the limited examination did not detect the fraud, nor, in the absence of a host of other tests of related records and documents which were not requested (or permitted), could it have.

5 Corporate Accountability and the Law

Recent publicity and activities of governmental bodies, particularly the Securities and Exchange Commission, concerning illegal or questionable corporate acts—such as bribes, political payoffs, and kickbacks—have focused attention once again on aspects of the accountability of management for corporate assets and the auditor's traditional concern with management's stewardship.[1]

Suggestions have been made by several congressional committees, the SEC, and others, that independent auditors should assume more responsibility for detection and disclosure of illegal or questionable acts by management. This section of the report of the Commission considers the implications of these suggestions and recommends actions that should be taken by various parties, including independent auditors.

Current attention has been devoted to certain types of illegal or questionable acts—primarily covert payments—but the auditor's responsibility for the detection and disclosure of the entire range of illegal acts that might be committed by clients needs to be explored. In addition, the present understanding by users of auditors' responsibilities for disclosure of litigation and claims is unclear.[2]

This section of the report suggests a framework within which the auditor, commensurate with his abilities, can respond to increasing calls for his assistance in improving corporate accountability. At the same time, it suggests increased responsibilities for lawyers in matters that are primarily legal in nature.

AN EVOLVING PUBLIC CONCERN

Society has always been concerned with illegal and questionable acts involving business, although as Beard noted, "Few really horrid crimes, without rational motive, may be imputed to businessmen. Seldom have they put out the eyes of competitors with hot irons or burned rival salesmen at the stake."[3]

Laws governing the conduct of business were developed in each society virtually as soon as business activities began.[4] In the United States, there have been several periods when particular attention was given to the conduct of businessmen and legislation was adopted to define and provide punishment for improper business activities.

Agitation by farmers and owners of smaller businesses in the last quarter of the nineteenth century produced the Interstate Commerce Act (1887) and the Sherman Antitrust Act (1890). After the turn of the twentieth century, the writings of "muckrakers" such as Ida Tarbell and Professor William Ripley inflamed public sentiment and combined with the activism of Presidents Theodore Roosevelt and William Taft to bring antitrust activity

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1. The auditor's traditional concern with misappropriation or misuse of corporate assets and related aspects of management's accountability are discussed in section 4.

2. The auditor's role in reporting on uncertainties is discussed in section 3.

3. Miriam Beard, *A History of the Businessman* (New York: The Macmillan Co., 1938), p. 3.

4. The first law defining an illegal business act may be the biblical prohibition, "Ye shall do no unrighteousness . . . in measures of length, or weight, or of quality" (Leviticus 19:35–36). The first accusation of a financially oriented illegal or questionable business act may well have occurred when the prophet Amos denounced the corrupt court of Israel for "making the ephah small, and the shekel great, and dealing falsely with balances. . ." (Amos 8:5–6).

to a peak.[5] The Clayton Act (1914) was enacted and the Federal Trade Commission was established during the Wilson administration. Nevertheless, the combination of less activism under Wilson and restrictive court decisions ended the progressive movement's campaign against business.

It was not until the administration of Franklin Roosevelt, spurred by public sentiment that blamed business for the depression, that another period of development of legislation and regulation of business started. In 1973, the Watergate scandal provided revelations of another form of questionable corporate conduct: payments made to the Committee to Reelect the President that were illegal under U.S. law.

Investigations and further disclosures stimulated by these initial revelations covered a wider spectrum of conduct. Attention shifted from domestic political payments to foreign political payments, then to other payments made in foreign countries and, more recently, to bribes paid within the United States to obtain business.[6] Although the specific types of conduct receiving attention will probably continue to change, it does not appear that the heightened concern with corporate accountability will diminish, nor should it.

Unclear Expectations of Society

The expectations of users of financial information with respect to the auditor's detection and disclosure of illegal or questionable acts are unclear.[7] However, a number of regulatory and legislative initiatives are under way that may provide some clarification of society's expectations.

Hearings have been held and reports have been issued by government bodies and agencies such as the Subcommittee on Multinational Corporations, chaired by Senator Frank Church, the Subcommittee on Oversight and Investigations, chaired by Congressman John Moss, and the President's Task Force on Questionable Corporate Payments. The SEC has made proposals that have been incorporated in some of the proposed legislation.[8] The SEC also encouraged corporations to make internal investigations to determine whether they had made illegal or questionable payments and, in some cases, brought suit against corporations to require disclosure. The SEC's efforts resulted in extensive publicity and revelations of illegal or questionable payments ranging from extremely small amounts to millions of dollars.

The current attention paid to illegal or questionable corporate payments emphasizes the widespread concern over corporate accountability. It seems clear that this concern will not remain confined to the actions that stimulated the initial interest. As noted earlier, the SEC has already indicated its interest in domestic commercial bribery and similar corrupt promotional activity.

Several interested groups have expressed the view that independent auditors should act in some way to improve corporate accountability in the areas of concern. Some have suggested that auditors should have a direct, active role in *enforcing* corporate account-

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5. For discussions of these periods, see Richard Hofstadter, *The Age of Reform* (New York: Knopf, 1956); and William Z. Ripley, ed., *Trusts, Pools and Corporations,* rev. ed. (Boston: Ginn and Co., 1916).

6. The first SEC proceeding involving domestic commercial practices is SEC v. Emersons Ltd. et al. (Civ. No. 75–0808 [D.D.C. May 11, 1976]), concerning promotional payments made by beer brewers and distributors to a restaurant chain (SEC Litigation Release No. 7392, May 11, 1976 [CCH Fed. Sec. L. Reptr., paragraph 95,544]).

7. A survey of opinions on questionable corporate activity is described in appendix B.

8. SEC Securities Exchange Act Release No. 34–13185, "Promotion of the Reliability of Financial Information, Prevention of the Concealment of Questionable or Illegal Corporate Payments and Practices and Disclosure of the Involvement of Management in Specified Types of Transactions," January 19, 1977. Proposals related to illegal payments are also included in S. 305, *Foreign Corrupt Practices Act of 1977.*

ability. For example, members of the staff of the SEC have asserted in speeches and articles that independent auditors should report illegal or questionable client conduct directly to the SEC.

The expectations of users, regulators, and legislators as to the appropriate responsibilities of the independent auditor are clouded by the lack of a clear definition of prohibited corporate conduct. Some illegal acts, such as tax evasion, have been well defined and are easily recognized by experienced auditors. Other illegal corporate acts, such as price fixing and price discrimination, are less clearly defined and less susceptible to detection in an audit. Also important, particularly for clarifying the auditor's responsibility, many of the illegal or questionable corporate acts are based on unspecified standards of business conduct. These standards are sometimes defined after the fact, and the notion of what is questionable appears to be in a process of continual evolution.

The recent revelations of corporate misconduct have generated significant reaction from many sectors of the United States political and economic system. Given the apparent widespread nature of such corporate acts, it is clear that a substantial gap exists between some corporate behavior and society's view of appropriate corporate conduct. The causes of this gap are too complex to permit us to recommend precise responsibilities for independent auditors in this area. Narrowing the gap will require action by the political system to define more clearly the responsibilities of all those involved, including corporate management, boards of directors, regulatory agencies, and auditors.

Confusion Over the Auditor's Responsibilities Concerning Illegal Acts by Clients

The auditor has traditionally acknowledged some responsibility for detecting misuse of corporate assets. However, the idea of misuse of corporate assets has been related to acts of fraud, such as misappropriation of assets by untrustworthy employees and managers, applied within the usual framework of quantitative measures of materiality.

The auditor's responsibility for detection and disclosure of illegal acts is less clear. By training and experience, auditors are knowledgeable about certain matters of business law. For example, auditors are familiar with the federal income tax laws and would be expected to recognize tax evasion by a client. Normal audit procedures will detect many types of tax evasion if material amounts are involved.

In specialized industries, violation of some laws might have a direct and material effect on amounts in financial statements. For example, lack of conformity with government contracting regulations could invalidate related receivables. Auditors normally consider such possibilities when planning and conducting their examinations.

Many auditors are familiar with the financial reporting and related provisions of the securities acts and, to a lesser extent, with financially oriented laws such as the Robinson-Patman Act and the antitrust statutes. Detection of some violations of the securities laws, such as failure to make required disclosures in financial statements, are an integral part of the auditor's responsibilities. However, other securities laws violations, such as insider trading, often involve acts by management that bear no relation to the accounting records of the entity.

Auditors are neither trained nor necessarily able to detect violations of those laws or of the myriad other laws that govern corporate conduct, and they have not traditionally been considered responsible for detecting such violations. Of course, any act that has economic consequences for the entity will ultimately affect its financial statements. However, such acts cannot be detected in an audit until they result in transactions or events that are ordinarily recorded.

Auditing standards are often not specific on the precise action that an auditor should take if he detects corporate acts that might be illegal. However, inaction is not an acceptable alternative. For example, if an auditor finds a material misstatement of fact in

another part of an annual report containing financial statements he has audited, SAS No. 8 advises that

> the action he takes will depend on his judgment in the particular circumstances. He should consider steps such as notifying his client in writing of his views concerning the information and consulting his legal counsel as to further appropriate action in the circumstances.[9]

If the auditor finds that financial statements of prior years reported on by a predecessor auditor may require revision, SAS No. 7 suggests that

> he should request his client to arrange a meeting among the three parties . . . and attempt to resolve the matter. If the client refuses or if the successor is not satisfied with the result, the successor auditor may be well advised to consult with his attorney in determining an appropriate course of further action.[10]

Recently, the Auditing Standards Executive Committee issued SAS No. 17 specifically on illegal acts by clients. If an illegal act has a material effect on the financial statements, the act must be disclosed. However, for any illegal act he detects, the auditor is advised that

> when an illegal act, including one that does not have a material effect on the financial statements, comes to the auditor's attention, he should consider the nature of the act and management's consideration once the matter is brought to their attention. If the client's board of directors, its audit committee, or other appropriate levels within the organization do not give appropriate consideration . . . to the illegal act, the auditor should consider withdrawing from the current engagement or dissociating himself from any future relationship with the client.[11]

The SAS also states that

> deciding whether there is a need to notify parties other than personnel within the client's organization of an illegal act is the responsibility of management. Generally, the auditor is under no obligation to notify those parties. . . .[12]

These Statements suggest some level of responsibility but do not seem to provide enough guidance in a very complex area, nor do they seem an adequate response to the strong political forces suggesting greater auditor action.

Limitations on the Auditor's Ability to Deal With Legal Matters

Several fundamental considerations suggest limits on the extent of the auditor's responsibility for detection and disclosure of the illegal acts of clients. Auditors cannot reasonably be expected to assume responsibilities for detection or disclosure of a client's violations of law in general. Auditors are primarily accountants, trained and experienced in activities

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9. Statement on Auditing Standards No. 8, *Other Information in Documents Containing Audited Financial Statements* (December 1975), paragraph 6 (AICPA, *Professional Standards,* vol. 1, AU section 550.06).

10. Statement on Auditing Standards No. 7, *Communications Between Predecessor and Successor Auditors* (October 1975), paragraph 10 (AICPA, *Professional Standards,* vol. 1, AU section 315.10).

11. Statement on Auditing Standards No. 17, *Illegal Acts by Clients* (January 1977), paragraph 18 (AICPA, *Professional Standards,* vol. 1, AU section 328.18).

12. Statement on Auditing Standards No. 17, paragraph 19.

that are basically financial. They are not lawyers nor are they criminal investigators, and they do not presently possess the training or skills of either group.

Similarly, in matters involving litigation against the corporation, the abilities of auditors are limited. They can readily ascertain the existence of litigation when provisions for losses are recorded in the accounts, when litigation is mentioned in documents such as the minutes of directors' meetings, or when they know of events that are likely to give rise to future claims. However, the auditor is not trained to recognize all the complex circumstances and processes that give rise to litigation and that suggest its outcome.

Society has developed an elaborate enforcement system to help assure compliance with its laws, including regulatory agencies, police, lawyers, courts, and prisons. Independent auditors—by tradition, training, and experience—have played a minor role in this system. Nevertheless, with the current increased concern with "white collar crime," some parties view independent auditors as public agents to be used to improve the functioning of the enforcement system as it relates to the conduct of business.

The public accounting profession must be responsive to society's needs for evolution of the scope of the services it provides. Section 6 of this report discusses a framework for such an evolution. However, the Commission believes that it would be inefficient and impractical for auditors to undertake responsibilities that would require the knowledge, skills, and experience of members of another profession, namely, law. Thus, the resolution of the issue should be within the framework of the conventional skills attributed to accountants and auditors, with possible long-term modification through education and training.

Expanding the Role of Lawyers

Society appears to want greater assurance on the compliance of corporations with laws and regulations. Securities lawyers now furnish opinions on the conformity of offerings of securities with the securities acts. Although the scope of these opinions is quite narrow, the concept underlying them could have wider applicability. In addition, lawyers of a corporation, at management's request, furnish auditors with information on litigation and other contingencies for disclosure in financial statements. This indirect arrangement is not the most efficient.

If society needs assurance on matters that are principally legal—the conformity of corporate actions with laws and regulations or information on the status of pending and future litigation—the assurance should be provided by those most capable of doing so—management assisted by its lawyers. Therefore, the Commission believes that a substantial portion of the work and responsibilities in these areas should fall on the corporate or outside legal counsel working in close cooperation with management and the independent auditor.

A FRAMEWORK FOR AUDITOR PARTICIPATION TO HELP ACHIEVE CORPORATE LEGAL ACCOUNTABILITY

The auditor must be able to approach the detection and disclosure of illegal or questionable acts by management within a defined and agreed framework.

Specifying Illegal or Questionable Acts

The required starting point is a clear specification of illegal or questionable acts. Several sources are available, and others will soon become available. In reporting on its voluntary disclosure program to numerous congressional committees, the SEC explained the types of acts that it believes must be disclosed. Many corporations have adopted statements of policy for employee and management conduct. Various legislative and regulatory

proposals would make specified acts illegal or define acts that must be disclosed. Several of these proposals contain provisions concerning maintaining accurate books and records and an adequate system of internal control. They also prohibit falsifying accounting records and making false statements to auditors.

Necessary Corporate Actions

Since the demands of society are for corporate accountability, the first responsibility should fall on corporations. Corporations should adopt and distribute to employees statements of policy indicating in detail the conduct that will not be tolerated. The statements of policy should also be made available to shareholders and others. Corporations must also adopt procedures to provide for effective monitoring of compliance. To the extent that independent auditors are to be involved in monitoring compliance with such policies, there must be an understanding and identification of the parts of the policy statement that can be audited.[13] For example, auditors might be expected to provide some assurance when disbursements of corporate funds are involved. On the other hand, auditors cannot deal with transactions not related to the corporate accounting system, such as the personal receipt of bribes by corporate executives.

Almost all of the corporate activities so far disclosed would not be material by conventional accounting standards. Consequently, if the independent auditor is to become more involved in detecting or disclosing such activities, the corporate accounting system and the controls over it must be revised as necessary to provide a greater possibility of detection. For example, some of the changes that will be required include more extensive controls over the activities of top executives, greater accountability for cash funds and intercorporate transfers, and more extensive documentation for payments to consultants and agents.

If a corporation has an internal audit staff, and most large organizations do, the internal auditor should participate in the design and implementation of the programs for achieving and enforcing corporate policy statements in this area, or the company should specifically arrange for the independent auditor to undertake a separate engagement. Designing a program for enforcing corporate policy is not a part of the audit function.

Recommendations on the Independent Auditor's Responsibilities

When a corporation has adopted a policy on corporate conduct and provided for monitoring compliance with it, the independent auditor can be expected to play a larger role in detecting and disclosing illegal or questionable acts.

Detecting Illegal or Questionable Acts. As explained in section 4, any acts that management conceals are difficult for the auditor to detect. The auditor will not always be able to detect material fraud, and illegal or questionable payments present even greater problems. They are more difficult to detect because the amounts involved are typically small in relation to financial statement amounts. Outside parties involved are usually anxious to keep the payments concealed, so collusion is common.

It would not be equitable if the auditor's failure to detect an illegal act placed him in the same legal jeopardy as the person who perpetrated the act. In the course of an audit, however, the independent auditor should be expected to detect those illegal or questionable acts that the exercise of professional skill and care would normally uncover.

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13. Procedures adopted to monitor compliance with such policies and identification of which policies are susceptible to audit can be documented in a separate memorandum prepared and agreed to by management, the board of directors (or its audit committee), and the independent auditor.

Additional guidance is necessary on the meaning of the appropriate "exercise of professional skill and care" in this area. Important elements would include guidance on the evaluation of areas of risk and exposure to illegal acts, recognition of warning signs of the existence of such acts, and development of audit procedures applicable in those circumstances. Although these considerations seem similar to those for the auditor's responsibility for the detection of fraud, the Commission has no similar specific recommendations, because, as explained earlier, the subject of illegal and questionable acts is evolving rapidly. However, we believe immediate steps should be taken to begin implementation of the proposals made in this section, even though some changes in them may later be necessary to adapt to changing circumstances.

If appropriate guidance on the exercise of skill and care in this area is developed, independent auditors should be willing to provide users with assurance on whether a company is taking effective action to control such conduct. The auditor should review the guidelines and policies and the procedures adopted to monitor compliance with them. The auditor should determine whether there are material weaknesses in the guidelines or in the related monitoring procedures, and indicate his conclusion on these matters in his report as illustrated in section 7.

It is doubtful that auditors can detect, with any regularity, willfully concealed illegal or questionable acts involving relatively small amounts. Therefore, any expression of assurance implying that the auditor knows such acts have not occurred, or that none have come to his attention, would be of no real value. However, auditors must continue to be aware of the possibility that illegal acts may have occurred and must evaluate the evidence obtained in the audit which may suggest that such acts have in fact occurred. Auditors should be aware that illegal or questionable acts involving immaterial amounts may raise important questions of disclosure. Widely disseminated policies, improved controls, monitoring by internal auditors, and tests of these procedures by independent auditors will help to deter such conduct and improve the possibility of its detection.

The Auditor's Response to Detected Illegal or Questionable Acts. The auditor's responsibility for detecting illegal or questionable acts must be distinguished from his responsibility for disclosing or taking other action when he has detected or otherwise discovered such acts. That is, problems related to finding illegal or questionable acts are quite different from those regarding the response once an act is detected.

In principle, at least, the problem of the illegal or questionable act that has already been ascertained appears more susceptible of solution. If an auditor has discovered an act that he believes is illegal or questionable, he can follow only one course: He must obtain consideration of that act at the appropriate level of authority within the entity.

This responsibility rests on the premise that conventional concepts of materiality, based principally on quantitative considerations, are inapplicable to known illegal or questionable acts. The auditor should not take it on himself to determine that some violations of the law or propriety are more or less serious than others.

Materiality in accounting is essentially an economic concept designed to reconcile the conflict between the almost limitless detail that confronts accountants and auditors with the needs of users for information in an understandable form. It has been difficult to develop precise guidance on determining materiality; indeed, a major project of the Financial Accounting Standards Board is an attempt to clarify this concept. Nevertheless, materiality is merely a convention designed to effect a workable reconciliation of conflicting economic demands. It is not a concept powerful enough to deal with issues of morality or legality, and it should not be invoked in such circumstances.

However, the inapplicability of the materiality concept to the auditor's decision as to whether to act does not imply that his actions should always be the same. The auditor

must obtain consideration appropriate to the circumstances of every illegal or questionable act. This involves at least three factors.

The first concerns the auditor's usual response to discovered irregularities. He must determine the extent to which the item might affect the financial statements. In the conventional audit of financial statements, the auditor must determine whether a possible irregularity could cause a material misstatement. If it could, he must perform enough additional or alternative audit procedures to assure himself of the extent and consequences of the irregularity.

The second factor is a comparison of the act with the standard of corporate conduct against which the auditor is conducting his examination. As previously explained, boards of directors, or other appropriate authorities, must set forth detailed and explicit codes of conduct if the auditor is to have a constructive and useful role in the area of illegal or questionable acts. That statement must stipulate, in reasonable detail, the types and magnitudes of infractions on which the board of directors wishes to take action and those which may be disposed of by corrective action by management.

The ability of the auditor to compare a detected act with the standard established by the corporation or other authority once again raises difficulties related to the auditor's limited legal training and experience. The auditor will invariably be confronted with acts that do not appear to be clearly legal or illegal. These problems can be reduced, if not eliminated, by careful preparation of the corporate policy statement. Corporate lawyers and the auditor must work with management, internal auditors, and the board of directors to explore and stipulate appropriate conduct in as many situations as possible.

Even with a well-drawn policy statement, the auditor will be confronted with acts or items whose conformity with policy is unclear. A procedure for ready consultation, presumably with corporate counsel, should be developed to provide the auditor with additional and comprehensive assistance. Such a procedure should, and will, involve the corporate counsel directly in this aspect of the audit. The auditor should maintain an attitude of readiness to explore questionable items. That is, there should be a deliberate bias toward pursuing any suspicious acts.

Finally, the possible need for public disclosure must be considered. The independent auditor's primary responsibility in the area of corporate accountability is to the shareholders. In a large corporation, the shareholders change continuously and do not exercise direct control. Therefore, the auditor's responsibility to the shareholders is often fulfilled through reporting to the corporation's board of directors. Illegal or questionable acts that come to the auditor's attention should be brought to the attention of the appropriate person or persons, as specified in the policy statement. The policy statement may identify management, the board of directors, or a committee of the board to deal with such matters. Management should inform the board of those acts that the policy statement requires be brought to their attention. The auditor also has a public responsibility, but that responsibility does not imply a requirement to disclose all to the public. Nevertheless, if the auditor concludes that the board of directors has made an inadequate response, public disclosure is necessary.

A Proposal for Reporting on Corporate Codes of Conduct. If the company has adopted a policy on illegal or questionable acts, the report by management in the annual report should include a statement that such a policy exists and that procedures have been implemented to monitor compliance. The auditor's report should describe his review of the policy and monitoring procedures and his conclusions on them. An example of the comments of management and the auditor is included in section 7. If a legislative or regulatory rule is adopted to require corporations to adopt and enforce codes of conduct, and if they fail to do so, that fact should be disclosed in the report by management discussed in section 7. If management does not disclose that fact, the independent

auditor's report should include a comment that no policy had been adopted or that the company did not establish a means to enforce the policy.

A Proposal for Increased Involvement of Lawyers

This section focuses primarily on illegal or questionable acts. However, the same considerations apply to the more general problem of legal claims against the corporation, particularly the limitations on the auditor's ability to deal with matters that are primarily legal.

Traditionally, the presentation of financial statements in conformity with generally accepted accounting principles has included a requirement that significant claims against the corporation or claims against its assets be disclosed. In the less litigious environment of past years, this requirement did not produce substantial problems. Disclosure of pending legal matters was often couched in vague and noncommittal terms to protect the corporation from apparent admissions of guilt or liability or to avoid stimulating additional litigation.

In recent years, a great deal more attention has been given to the need to disclose pending and foreseeable legal claims. The result of present auditing requirements is that the auditor, the client, and the lawyer become involved in a rather elaborate procedure for determining which legal claims need to be disclosed.

The Commission does not believe that the present structure and division of responsibilities in this area are efficient or effective. Instead, we suggest that management's responsibility for disclosure of litigation, claims, and assessments can be better fulfilled if greater reliance is placed on, and greater assistance obtained from, corporate or outside counsel, who would thus assume greater responsibility for the disclosure of legal matters. As discussed throughout this section, the auditor has only limited ability to evaluate the quality and completeness of disclosure of legal matters; management and its legal advisors should provide whatever assurances are necessary for such matters. We believe that the manner in which litigation and legal claims are disclosed should be improved. The Commission's recommendations on disclosure of uncertainties, including legal matters, are explained in section 3.

The new reporting format suggested by the Commission in section 7 of this report would accommodate this proposal. The report by management could include the statement that management believes that all material uncertainties have been appropriately accounted for or disclosed, and that it has consulted with legal counsel with respect to the need for, and the nature of, the accounting for or disclosure of legal matters. Alternatively, a separate report by legal counsel might be included. The auditor's responsibility would be to review the information and the representations of management and counsel to determine that the financial statements properly reflect the information provided.

6 The Boundaries of the Auditor's Role and Its Extension

The activities of auditors and the scope of their work will change continuously as business and the attitudes toward it evolve. This section presents a framework for the evolution of the auditor's role to accommodate changing business and investment needs. It is concerned with the boundaries of that role—the activities that should become a part of it and those that should be excluded from it.[1]

Sections 2 through 5 consider current questions on the responsibilities of auditors and suggest ways in which those responsibilities can be more effectively fulfilled. The Commission has also been conscious of the need to suggest long-term direction as well as to propose solutions to current problems.

This section provides long-term direction for change in the audit function. However, short-term solutions should be compatible with that direction. The changes recommended in sections 2 through 5 are consistent with the boundaries and framework proposed in this section, but they do not depend on these. The Commission's suggestions in sections 2 through 5 could be adopted by the profession, or others, before the changes proposed in this section. Similarly, not all the recommendations made in this section need to be adopted simultaneously. We have, therefore, tried to identify important steps in the evolution of the audit function. For example, as explained later, the first change recommended is expansion of the study and evaluation of controls, and it should be made immediately.

THE SETTING OF THE AUDIT FUNCTION AND CONSIDERATIONS AFFECTING ITS EXTENSION

The auditor serves in a market economy. Thus, it would seem natural for the market to determine the extent of audit services needed. The public accounting profession might be expected to establish minimum standards to assure the continuing value of its reputation. However, beyond that minimum, the market would determine the extent of audit services through the choices made by users—management, boards of directors, investors, creditors, and underwriters—as expressed by their willingness to pay for particular types of assurance on particular information.

This arrangement has the obvious attraction of promising needed services at a fair price without the added costs of regulation. However, the extent of audit services cannot be determined by a free market in the mixed economy of the United States in the 1970s.

Determinants of the Audit Function

The demand for audit services arose on the basis of a free market, and the public accounting profession grew rapidly in the first part of this century on that basis. Today, however, auditing services are subject to substantial government regulation. A minimum demand for audit services is established by the securities acts, which require audits of most corporations whose securities are publicly traded. Other federal agencies also have

1. Not all services a CPA or a public accounting firm may offer are part of the audit function. The limits that may be necessary on services other than the audit function are considered in section 9.

audit requirements. For example, recent legislation requires independent audits at least every three years of municipalities receiving general revenue-sharing funds.[2]

Of course, there is also a private demand for independent audits. The responses of the "Big Eight" accounting firms to the staff study of the Senate Subcommittee on Reports, Accounting and Management showed that they have on the average over thirteen times as many privately owned audit clients as publicly owned clients.[3] The practices of smaller accounting firms would show an even higher proportion of privately owned clients. Nevertheless, the government exercises significant influence over the extent of audit services.

Generally, this influence is achieved by working with the private sector rather than by specific control. By 1928, most companies listed on the New York Stock Exchange published financial statements examined by independent auditors. The later NYSE and SEC requirements made mandatory a practice that had already been accepted by many corporations. The securities acts gave statutory support to what was then considered to be the best practice.[4]

The present system of regulation is a mixture of private and public action. The SEC requires that audits of financial statements filed under the securities acts be conducted in accordance with generally accepted auditing standards and that the statements be prepared in conformity with generally accepted accounting principles. The development of generally accepted auditing standards and generally accepted accounting principles is nominally in the private sector. However, as described in section 10 of this report, the SEC works closely with the public accounting profession and other private agencies, such as the Financial Accounting Standards Board, to achieve change.

Changes that appear to have originated with the profession are often the result of SEC suggestions or action. On the other hand, changes that appear to have originated with the SEC often have previously been adopted by leading companies and the public accounting profession. The SEC's recent requirement for disclosure of replacement cost information is one of the rare requirements for accounting information not already disclosed by at least a significant minority of companies.

Benefit-Cost Analysis to Determine the Scope of the Audit Function

Benefit-cost analysis attempts to simulate the decisions that would be made by a rational and informed market, if one existed. It is a general term to describe several techniques used to allocate resources when market prices are not available. The costs and benefits of given courses of action are priced—to the extent possible—and a comparison is made to determine the most desirable action. The first extensive applications were attempts to allocate resources for national defense.[5] The techniques have since been applied with varying degrees of effectiveness to other problems of government resource allocation and to social issues.[6]

Benefit-cost analysis may in the long run provide a means of determining the extent of audit services. For example, one approach suggests that the benefit of an audit is the

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2. P.L. 94–488.

3. Based on a tabulation of responses to a questionnaire in U.S. Senate, Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, *The Accounting Establishment: A Staff Study,* December 1976, pp. 30–31.

4. J. Wiesen, "Congressional and SEC Expectations Regarding Auditors' Duties," December 1976 (described in appendix B).

5. See, for example, Charles Hitch and Roland McKean, *The Economics of Defense in the Nuclear Age* (Cambridge, Mass.: Harvard University Press, 1960).

6. See, for example, Lee J. Seidler and Lynn L. Seidler, *Social Accounting: Theory, Issues and Cases* (Santa Barbara, Calif.: Wiley/Hamilton, 1975).

prevention or discovery of misstatements or omissions in financial information. The costs are the audit fee and related costs to the entity. The costs of limiting the scope of the audit are the losses of investors caused by inadequate financial information. Benefit-cost analysis suggests that the needed extent of auditing is achieved when the incremental cost of finding or preventing another misstatement or omission is equal to the loss that would be sustained by investors from not finding or deterring it.

Early in its work the Commission undertook research on the application of benefit-cost techniques to auditing. The goal was a framework for consideration of proposed extensions of the audit function. The research led to a number of promising approaches and direction for future research.[7] Unfortunately, the researcher and the Commission were forced to conclude that not enough data were available to permit application of the techniques in the near future. We believe additional research on this approach would be worthwhile.

The Commission has nevertheless attempted, although subjectively, to apply the rule that benefits and costs must be carefully considered in making recommendations. Also, we have been particularly conscious of the cost of failing to provide services that are needed. Auditors have an important role in society. Their role is supported by the government, for example, through state licensing of "certified public accountants" and statutory requirements for audits. Government support creates obligations as well as rewards. The obligation the profession assumes is to perform its role in the public interest.

If society needs new services, the public accounting profession should meet those needs within its abilities to deliver the requested services. If auditors repeatedly fail to respond to reasonable requests for new services, the political system will alter the current arrangements.

Toward a Framework

In the absence of precise benefit-cost measurements, some framework, even if subjective, is necessary to guide the development of the audit function in the changing business environment. Recent years have witnessed diverse demands to expand the scope of the auditor's responsibilities in areas such as forecasts, interim reporting, and illegal actions of management. The responses of the profession, firms, and individual members have often been contradictory, fragmented, and negative. The demands on the profession will grow and continued negative responses will reduce the ability of the profession to influence the direction of change. Therefore, in this section of the report, the Commission suggests the adoption of several changes in the audit function and related changes in generally accepted auditing standards that it believes are necessary for an orderly evolution of the audit function.

THE NEED TO EXPAND THE AUDIT FUNCTION

When he accepts an audit engagement, the auditor becomes an intermediary in one of an entity's relationships to society: the accountability of the entity and its management to users of its financial information. In recent times, this relationship has undergone dramatic change.

Changes in Corporate Financial Reporting

At the beginning of the century, published financial information consisted of little more than an abbreviated, annual balance sheet and income statement issued voluntarily by

7. See Melvin F. Shakun, "Cost/Benefit Study of Auditing: Preliminary Report for the Commission on Auditors' Responsibilities," March 1976 (described in appendix B).

management. As time passed, new types of information were published by some companies. When this information was considered valuable, competition often resulted in others following the lead.[8] Gradually, a body of accounting and reporting customs, conventions, and procedures—generally accepted accounting principles—developed. Actions by the NYSE, establishment of accounting standard-setting bodies, and, particularly, enactment of the federal securities laws institutionalized these practices. Reporting innovations by the few became requirements for all.

During the first half of this century, financial information grew primarily through disclosure of greater detail on more matters, disclosed annually. This trend has continued, producing disclosure of more details on the amounts presented in financial statements and expanded narrative explanation of those amounts and related matters. At the same time, there has been a tendency to require more incisive presentation of information not disclosed in the past because of the potential harmful effect on the corporation, such as details of litigation and sales and earnings by product line.

Expansion of the number of individual investors after World War II created a need for increased disclosure. In the 1960s and 1970s, other developments influenced trends in disclosure. Regulation of the securities markets and of financial information for those markets by the SEC and NYSE increased. The relative importance of institutional investors —such as banks, pension funds, insurance companies, and mutual funds—increased, while investment specialists—such as financial analysts, investment advisors, and fund managers—became more sophisticated. Gradually, emphasis in the administration of the federal securities laws shifted from disclosure for the initial distribution of securities (prospectuses) to development of a continuous flow of information about companies whose securities are publicly traded.

These trends caused changes in the types of information required. There is more disclosure of financial information during the year and disclosure of more interpretive information. Interim financial reporting has steadily expanded. Annual reports often include a great deal of interpretive information in addition to financial statements, such as a financial highlights section and management's analysis of changes in earnings.

Increased Emphasis on Accountability

The trends in corporate financial reporting have not been limited to increasing the quantity of information and improving its quality. Users are interested in financial information because of their interest in the economic conditions and underlying events. Users are interested in management's stewardship over corporate assets and the quality of the controls over the accounting system that produces the financial information. Recent revelations of illegal and questionable payments by many corporations have focused attention on corporate accountability and the importance of controls over the accounting system.[9]

Users of financial information are interested in whether controls over the accounting system are adequate to help reduce one of the risks of doing business—loss of assets through unauthorized use or misappropriation.

Users of financial information are also interested in whether controls are adequate to produce reliable financial information. Research indicates that financial information affects securities prices before that information has been audited. Weaknesses in controls

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8. This gradual evolution in financial reporting, while accurate in the aggregate, does not necessarily apply to each company. For example, the first annual report of United States Steel Company (1903) contained greater disclosure than is provided by most companies today.

9. Section 5 considers the auditor's responsibility for detecting and disclosing illegal or questionable payments.

can, therefore, result in faulty financial information that affects securities markets before it can be corrected by audit.

Management is responsible for establishing and maintaining controls over the accounting system. There is a growing body of thought that users need to be informed, as part of adequate disclosure, about the condition of the controls and management's response to suggestions by the independent auditor for correcting weaknesses.[10] Users of financial information who consider the condition of controls over the accounting system to be significant, such as some banks and investors in private placements, can sometimes obtain such information. Several government agencies, including the SEC, the Comptroller of the Currency, and the Federal Home Loan Bank Board, require reports on controls of some types of companies. Most investors and analysts, however, now have only limited ability to acquire such information.

The Need for Corresponding Changes in the Audit Function

Until recently, the trend in corporate financial reporting has been to increase the information in annual financial statements. Since audits historically have been conducted annually, the new information caused little difficulty for auditors. However, the concentration on annual financial statements has tended to create an unfortunate boundary. By restricting his public association with financial information predominately to annual financial statements, the auditor has implicitly encouraged the notion that his function is a periodic examination resulting in intermittent reports on information. However, this notion is contrary to trends both in financial reporting and in the arrangements for audits.

Relationships between the auditor and the company tend to be continuous.[11] The trend in financial disclosure is also to a continuous flow of information. When annual financial statements were the primary source of financial information about a company, a once-a-year audit of the financial statements was adequate. Today, however, annual financial statements are a decreasing part of the financial information used by shareholders and creditors.

Much of the financial information used by shareholders and creditors is produced by essentially the same process that produces annual financial statements. For example, even though certain modifications to the process are necessary, interim financial information is derived from the same accounting system, and its quality is affected by the controls over that system. The auditor with a continuing relationship with a company is uniquely situated to provide some degree of assurance that the information has been prepared responsibly. Not all financial information needs to be audited. However, if the auditor would increase his involvement with the company's financial reporting process, he would be able to offer some assurance on much of the financial information that is not now audited.

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10. A discussion of investors' interest in the adequacy of internal controls of a company whose securities they own or may consider purchasing is contained in Marilyn V. Brown, "The Auditor and Internal Controls: An Analyst's View," October 1976 (described in appendix B).

11. The continuous nature of the relationship is highlighted by the SEC's Form 8-K requirement that a company quickly inform the public whenever it changes auditors. The fact that the relationship is normally continuous has also been recognized in Statements on Auditing Standards. SAS No. 7, *Communications Between Predecessor and Successor Auditors* (October 1975) (AICPA, *Professional Standards,* vol. 1, AU section 315), requires a successor auditor to communicate with his predecessor on an engagement, and SAS No. 15, *Reports on Comparative Financial Statements* (December 1976) (AICPA, *Professional Standards,* vol. 1, AU section 505), explains the reporting responsibilities of a "continuing auditor" who has examined the financial statements of the current period and of one or more consecutive immediate prior periods.

THE BOUNDARIES OF THE AUDIT FUNCTION

Identifying the boundaries of the audit function provides a framework for expansion so that changes in the function need not be merely ad hoc solutions to specific issues. The auditor's association with interim information, other financial information in the annual report, or earnings forecasts should not be approached as separate services considered in isolation, but should be approached by examining their relation to the company's financial reporting process and the auditor's involvement with it.

The Purpose of Identifying Boundaries

The customs and traditions of the audit function and the mixed system of private and public regulation in which it exists create the boundaries of the audit function. An examination of the boundaries of the audit function is necessary to determine which of the present boundaries may be relaxed; boundaries exist, but they need not be exhaustively identified. Exhaustive identification is not only unnecessary, but probably unfruitful as well.

Gradual change toward identified goals is possible, but complete restructuring of an existing function to make it compatible with ideal, abstract criteria is both unrealistic and dangerous. The danger arises because of the difficulty of foreseeing all the effects of implementing criteria that seem acceptable in the abstract.

We agree with the view expressed by a group appointed by the American Accounting Association to study auditing concepts:

> In the final analysis, any definition of the subject matter to which the auditing process might be applied is arbitrary and artificial. It is mostly tradition that has led us to the "economics" focus of auditing. In practice, the auditor's *competence* and the existence of *operational criteria* dictate the boundaries of the subject matter to be investigated. . . .[12]

Customs and traditions usually develop as a result of long periods of trial and error; they represent workable responses to firsthand experience with problems. Consequently, traditional boundaries should be respected; they should be abandoned only when they can be demonstrated to have outlived their usefulness, or when they conflict and one can be demonstrated to take precedence over another.

A primary traditional boundary of the audit function has been annual financial statements. We believe that adherence to this boundary is no longer responsive to the business and investment needs the audit function serves; the linking of auditing to annual financial statements can and should be broken. This break is feasible because the boundary of annual financial statements is only one convenient means for specifying the responsibility to report information and assuring that information to be audited possesses certain characteristics.

The Responsibility to Report Information

Financial reporting is the responsibility of management; determining whether management has fulfilled that responsibility is the obligation of the auditor. This sequence of responsibility has often been recognized in court decisions and the actions of regulatory agencies. For example, the SEC has stated,

> The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management.

12. Committee on Basic Auditing Concepts, *A Statement of Basic Auditing Concepts,* Studies in Accounting Research No. 6 (Sarasota, Fla.: American Accounting Association, 1973), p. 5.

> Management does not discharge its obligations in this respect by employment of independent public accountants, however reputable. . . . [An auditor's opinion is] required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting.[13]

Few auditors, for example, were concerned with the present value of lease commitments before related disclosure requirements were adopted. The auditor provides an objective evaluation of management's presentation of information. He should not become an originator or interpreter of information.

This division of responsibility makes sense. Management is accountable to shareholders and creditors; since there is an inherent potential conflict of interest in the relationship, shareholders and creditors look to the independent auditor for assurance that management has discharged its accountability. For the auditor rather than management to assume an obligation to disclose financial information would inappropriately change the character of the auditor's role. This fundamental separation of the roles of management and the auditor must be maintained. However, it can be maintained without limiting auditing to annual financial statements.

The Characteristics of Audited Information

The boundary of annual financial statements also assures that information to be audited will possess certain characteristics. While this boundary has been convenient for auditors, we believe continued adherence to it will not serve users adequately. The important characteristics achieved by the current boundary of annual financial statements can be retained if the auditor's competence is relevant to verifying the information and the information is produced by the accounting system.

The Competence of Auditors. As is discussed in section 1, the audit function originated in the practice of accounting. At present, the usual education and training of auditors are concentrated in the discipline of accounting. While most CPA firms have specialists in taxes and some have specialists in management services, the firms are principally firms of accountants and auditors. Some public accounting firms might have enough specialists in other fields to perform some audits of data other than accounting information, but no firm could do such audits on a broad basis today.

In the immediate future, it would be unreasonable to expect the audit function to include information routinely that is largely based on disciplines other than accounting. Users of many types of information may need assurance that the information has been prepared in an honest and responsible manner. When this need can be met by individuals who are trained principally in accounting and auditing, it is reasonable for auditors to provide it. However, few people would take comfort from assurance provided by auditors on matters outside their competence, such as a company's compliance with fair employment practices or antitrust laws. Most would look to lawyers in these areas. Similarly, most consumers would look to engineers or scientists for assurances about the safety or efficacy of a company's products. It is now generally agreed, however, that an auditor should be concerned with such matters if they would have a material adverse effect on the financial position of the company. The apparent contradiction in this expectation is explored in section 5.

No one would be able to develop and maintain expert knowledge of all disciplines that affect business. This limitation is even more significant for fields of knowledge outside business. For these reasons, the Commission believes that the information with which

13. "In the Matter of Interstate Hosiery Mills, Inc.," 4 S.E.C. 706, 721 (1939), quoted in SEC Accounting Series Release No. 62 (1947).

the auditor is associated should be limited to information of an accounting and financial nature.[14]

The Importance of Verifiable Information. The term *verification* was once popular in the literature of auditing. It has given way to other terms, but the basic notion remains a part of accounting and auditing. An important part of the auditor's responsibilities is verifying that information presented by management is based on fact.

Historically, accounting information has had verifiability built into it. That is, accounting begins with verifiable facts—transactions and events. Even though various measurement methods that transform the information are applied in the recording and presentation of accounting information, the information is based on facts and can usually be traced back to them.

However, the preparation of financial information requires many estimates that may incorporate past experience but that are largely unsupported by facts. Estimates of liabilities under product warranties are of this nature. For some accounting measurements an objective basis does not exist. In the allocation of a joint cost to income, the total cost is known with certainty, but the amount chargeable to income in any one period cannot be objectively determined; it can only be arbitrarily allocated.

Experience indicates, as might be expected, that auditors have relatively few problems providing assurance on the validity of presentation of factual matters, such as the balance of the cash account, but they often encounter difficulties with estimates and allocations. Section 2 discusses this problem as it relates to the selection and application of accounting principles.

This boundary is not absolute; the audit function already includes items that lack a factual basis because of the nature of accounting information. Nevertheless, the audit function is more effective when applied to matters with a factual base and less effective to the extent that information lacks that support.

The Importance of the Accounting System. The preparation of financial statements starts with data documented by an accounting system. Accounting systems and the controls over them make possible a comprehensive summary of the myriad, diverse transactions of the typical business. These systems are an important source of information to the auditor, as well as to management.

While the financial reporting process has other important elements, the accounting system provides its base. For this reason, the accounting system establishes the most important boundary for the audit function. This boundary, however, is not static. As the accounting system develops, the audit function can expand accordingly. For example, if the accounting system develops to include more forward-looking information, that information can then be included in the audit function. One possible extension of the accounting system into the future would be to include data on backlogs of sales orders and purchase orders.[15] However, for this data to be effectively audited, the commitments would need to be recorded in the accounting system and appropriate controls over recording would need to be established.

The accounting system and the controls over it provide a discipline for the accumulation of information that permits the information to be verified. However, not all information

14. In some instances, the auditor is now required to evaluate information that is not of a financial or accounting nature, such as the status of litigation. As discussed in section 5, the confusion that has surrounded this unusual obligation may stem from its lying outside the usual purview and abilities of auditors and accountants.

15. The extension of the accounting system to future resources, including commitment accounting, is discussed in Yuji Ijiri, *Theory of Accounting Measurement,* Studies in Accounting Research No. 10 (Sarasota, Fla.: American Accounting Association, 1975), ch. 8.

needed for presenting financial information can be obtained directly from the accounting system. For example, information about material contingencies must be disclosed, as explained in section 3, but may not be recorded in the accounting system. As explained earlier, many amounts must be estimated; for example, amounts for sales and accounts receivable are the result of accumulating recorded transactions, but the related allowance for returns and uncollectible accounts requires estimates involving a great deal of judgment.

Such information is a recognized part of the financial reporting process, and evaluation of management's judgment in these areas is an important part of the auditor's responsibilities. The information has gradually become part of the financial reporting process as business has become more complex and accrual accounting measurements correspondingly have become more sophisticated. These changes have made the auditor's responsibility to evaluate management's judgment more difficult. Indeed, the Commission's review of significant cases against auditors and a survey of cases performed for the Commission disclosed that a high proportion of the instances in which auditors had difficulties were concerned with these areas of accounting.[16] For example, the alleged improper application of the percentage-of-completion method of accounting, which requires management to make subjective determinations of "completion" outside the normal accounting system, was a common element.

From the narrow perspective of the security of the auditor, it would be desirable to reduce association with such information. However, it would be neither realistic nor desirable to take such a narrow perspective. The auditor's needs cannot be the sole determinant of the types of information included in the accounting system. Nevertheless, the boundaries of verifiability and the accounting system provide criteria against which new responsibilities, and the risks associated with them, can be tested.

Removing the Boundary of Annual Financial Statements

As noted earlier in this section, significant changes in American business and financial markets have produced demands for more current financial information and a greater interest in improving the accountability of corporate management. Both trends appear to be based on well-established needs of users. Auditors should respond to the changes suggested by these trends.

After extensive consideration of the various issues before it, the Commission has concluded that the traditional association of independent auditors with annual financial statements is an obsolete, limited concept. The changing business and investment environment requires a more flexible and timely form of association, and the audit function should evolve in that direction.

We believe that the audit function can and should expand to include information of an accounting and financial nature that management has a responsibility to report if the auditor's competence is relevant to verifying the information and that information is produced by the accounting system.

NEED AND MECHANISM FOR EXPANSION OF THE AUDIT FUNCTION

Repeated demands have been made in recent years for expansion of the audit function, and the public accounting profession must respond constructively. The first portion of this section has described working boundaries for expansion of the audit function. This part suggests a mechanism—principally through increased involvement in a company's

16. A survey by major CPA firms of claims in litigation and staff analyses of cases involving alleged audit failures are described in appendix B.

financial reporting process, starting with a more comprehensive study and evaluation of controls over the accounting system—that will permit more systematic and constructive responses. Related changes in the form and timing of reporting would be required.

Auditing the Financial Reporting Process

The audit should be considered a "function" to be performed during a *period of time,* rather than an audit of a *particular set* of financial statements.[17] The present audit of financial statements should be expanded to include more elements of the corporate financial reporting process. The annual financial statements should be only one, although the most important, of the elements audited. Eventually, the audit function should expand to include all important elements of the financial reporting process. The expansion should begin with the accounting system and the controls over it. The introduction of the accounting system and controls over it as separate elements of the audit would add a new aspect to independent auditing—the need to examine and report on the functioning of a process.

Expanded Study and Evaluation of Internal Control

The first step in implementing the Commission's proposal, which should be adopted immediately, would be to require the auditor to expand his study and evaluation of the controls over the accounting system to form a conclusion on the functioning of the system during the year. The auditor may find material weaknesses in the internal accounting control system. If the weaknesses are not corrected, material deficiencies are likely in the preparation of accounting information or in the control of the corporation's assets. In those circumstances, the auditor could not provide assurances on the control system.

The existence of uncorrected material weaknesses would also prevent the auditor from providing assurance on interim information—the second stage in the evolution contemplated by the proposed framework. An audit could still be made of the annual financial statements, although disclosure of the weaknesses in the controls would be required.

The Effect on Auditing Practice. In present audits of annual financial statements, the study and evaluation of internal accounting control is made for a limited purpose.[18] The auditor must test the system only if he intends to rely on it in determining the nature, timing, or extent of other audit procedures. He need not test the entire system, and his study and evaluation might not include significant parts of the system if he does not plan to rely on those parts.

The auditor may sometimes decide that an item in the financial statements can be substantiated with less effort by not relying on internal control, and may omit testing of the related control procedures. The auditor may also sometimes decide that some part of the internal accounting control system has weaknesses, and in that event he will not test the functioning of controls already known to be inadequate.

This point is widely misunderstood. For example, the staff study of the Subcommittee on Reports, Accounting and Management views "checking the recordkeeping system

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17. The relationship recommended by the Commission is similar in some respects to the "auditor-of-record" role advocated by some commissioners and staff of the SEC. However, since the concept of the auditor-of-record has been described only briefly in a few speeches, a detailed comparison is not possible.

18. "Internal accounting control" is the phrase typically used to describe the controls over the accounting system. The auditor's responsibilities in its study and evaluation are described in Statement on Auditing Standards No. 1 (November 1972), section 320 (AICPA, *Professional Standards,* vol. 1, AU section 320).

periodically to assure that it is effective" as part of "the basic services which have been performed traditionally by the accounting profession."[19] That belief is incorrect.

The auditor now reviews internal accounting control only to determine the extent of other audit tests. The present requirement does not arise from an attempt to avoid responsibility for auditing internal controls. The existing relationship of internal control to the audit serves another purpose—to use the company's internal control system, when satisfactory, to reduce the cost of the audit. The idea is not new. In 1920, Montgomery noted that "if the auditor has satisfied himself that the system of internal check *is* adequate, he will not attempt to duplicate work which has been properly performed by someone else."[20]

As the initial step in the evolution of the audit function the Commission considers desirable, the auditor's study and evaluation of the internal accounting control system should be expanded beyond what is now required by generally accepted auditing standards. The auditor should be required to review and test the entire system. The objective of this study and evaluation would be to enable the auditor to reach a conclusion on whether controls over each significant part of the accounting system provide reasonable, though not absolute, assurance that the system is free of material weaknesses.

The Effect on Reporting Practice. As explained earlier, the auditor now evaluates the client's controls over the accounting system for the purpose of determining the extent of his audit tests.[21] Only if controls are so lacking that the financial information produced by the accounting system cannot be audited does the auditor refer to the controls. In those circumstances, the auditor would disclaim an opinion based on the inadequate scope of his audit. If the auditor is able to extend his procedures to compensate for weaknesses in internal control, he does not refer to those weaknesses in his report. However, the auditor typically informs management of weaknesses and suggests improvements in controls in a so-called management letter.

Users of financial information have a legitimate interest in the condition of the controls over the accounting system and management's response to the suggestions of the auditor for correction of weaknesses. The Commission believes those matters should be disclosed in the proposed report by management.[22] It is consistent with the normal responsibilities for financial reporting that primary reporting responsibility be assigned to management, with a report by the auditor on management's representations.

The Commission also believes that the auditor should report on whether he agrees with management's description of the company's controls and should describe material uncorrected weaknesses not disclosed in that report. However, the protection provided by internal accounting control procedures for the security of assets and the reliability of financial information is relative, not unlimited: Other things being equal, good controls provide more security and reliability than do poor controls. Controls can be carelessly

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19. U.S. Senate Subcommittee on Reports, Accounting and Management, *The Accounting Establishment,* p. 33.

20. Robert H. Montgomery, *Auditing Theory and Practice* (New York: Ronald Press Company, 1920), p. 50.

21. In section 4 we recommend that the auditor's study and evaluation of internal control be extended beyond what is now required. The auditor should be particularly concerned with controls that have a significant bearing on the prevention and detection of fraud. As noted in section 4, as early as 1933 the NYSE stated that "auditors should assume a definite responsibility for satisfying themselves that the system of internal check provides adequate safeguards and should protect the company against any defalcations of major importance."

22. In Securities Exchange Act Release No. 13185, January 19, 1977, the SEC proposed requiring managements to maintain an adequate system of internal control and indicated interest in requiring reporting to shareholders on internal control.

or mistakenly applied, can break down, or can be circumvented or overridden. Consequently, reports to users on controls should include a description of their inherent limitations.

Users have the right to expect the independent auditor to inform them of any material uncorrected weaknesses in controls not disclosed and discussed by the management:

> It appears entirely within reason to recommend that an independent auditor disclose to all concerned any weaknesses in internal control which in his opinion are sufficiently important to influence the judgment of one reading and acting on the financial statements.[23]

If the auditor expands his study and evaluation of internal accounting control, he will be in a position to evaluate management's disclosure of information on control systems and report on the information to the extent that it relates to the controls over the accounting system. The form of reporting on controls in the annual report is explained and illustrated in section 7.

Timely Involvement in the Financial Reporting Process

The next step in the evolution of the audit function proposed by the Commission is closely related to the first and, indeed, would only be feasible if preceded by an expanded study and evaluation of the internal accounting control system. After experience is gained with this expanded study and evaluation, the audit function should expand to include obtaining an understanding of the process used by the company to prepare significant financial information released regularly during the year. However, separate audits of the information would not be required. Indeed, some users of financial information do not desire audits of information released during the year. For example, a committee of the Financial Analysts Federation has stated that

> members of the Committee have little or no desire for a certification of [audit of and expression of opinion on] interim financial statements. . . .
>
> An auditor's formal association with interim statements would not per se increase their credibility. An annual audit is deemed adequate. . . .
>
> This view of the Committee members . . . rests in part on the assumption that the auditors are involved with a firm's financial reports throughout the year. . . .[24]

The assumption made by the financial analysts that the auditor is involved in a company's financial reporting process throughout the year is only sometimes true. Gen-

23. R.K. Mautz and H.A. Sharaf, *The Philosophy of Auditing* (Sarasota, Fla.: American Accounting Association, 1961), p. 153. A majority of respondents to a survey on the auditor's standard report conducted in connection with our work (described in appendix B) indicated they now believe they receive moderate to very high assurance from the report that the accounting system of the company is adequate for producing proper financial statements and that the internal accounting control system was adequately designed to prevent fraud, conflict-of-interest situations, and other irregularities. The results of surveys in other countries indicate similar beliefs by users; for example, G.W. Beck, *Public Accountants in Australia: Their Social Role* (Ph.D. dissertation, University of Queensland, Brisbane, Australia, 1972), and T.A. Lee, "The Nature of Auditing and Its Objectives," *Accountancy* (England) 81 (April 1970): 292–96.

24. Financial Accounting Policy Committee of the Financial Analysts Federation, letter to the SEC concerning proposals to increase disclosure of interim results, File S7–542, March 14, 1975.

erally accepted auditing standards do not require this involvement.[25] Consequently, the auditor's involvement now varies greatly. As the second step in the proposed evolution of the audit function, the auditor would be required to review the company's financial reporting process for preparing quarterly information released to the public.

The auditor's involvement in the process can result in a general improvement in financial reporting even if it is limited to a review of the process rather than an audit. A review is likely to inhibit practices that cannot stand even superficial scrutiny. However, the main benefit of a review of a process is that it can be expected to improve the preparation of information.

The auditor's inquiries about the procedures used by management to make estimates or identify disclosures that should be made are likely to result in extra care in performing the procedures and documenting their execution. Traditionally, the annual audit has been a focal point for this closing process. Documentation is prepared to support the recording of estimates and to permit the auditor to assess the reasonableness of the estimates.

Management must engage in a similar process during the year when it publishes information for shorter periods such as quarters. However, until recently the auditor's involvement in the financial reporting process during the year has been limited. He has often been concerned with the accumulation of information in the accounting system during the year because that information is included in the annual financial statements. However, the timing and extent of his involvement have varied.

Greater involvement in the financial reporting process during the year would require some changes in the way audits are conducted. The audit of the accounting system often, although not always, includes tests of the accumulation of accounting information throughout the year. Under our proposal, tests throughout the year would be required. It would also be necessary for the auditor to obtain an understanding of the process used to make estimates and disclosures.

The Extent of Involvement in the Financial Reporting Process

The procedures for a "limited review" of interim financial information are specified in Statement on Auditing Standards No. 10.[26] The review which the Commission believes is desirable would probably be more extensive than the "limited review" contemplated by SAS No. 10, although it would be similar in some respects. A review would be less extensive than an audit of quarterly information. A "limited review" is limited because it is less extensive than an audit; "review" in ordinary and technical usage in the United States has no meaning that distinguishes it from an examination.

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25. Under SEC Accounting Series Release No. 177, September 10, 1975, auditors must be involved with the quarterly information of certain very large companies whose securities are widely traded. That involvement, however, need not be maintained throughout the year. Companies that fall under the requirements of ASR No. 177 are those that had income after taxes (but before extraordinary items and cumulative effects of accounting changes) of $250,000 or more for each of the last three years, or those that had total assets of $200 million or more and whose securities meet several criteria establishing that they are widely traded.

26. Before adopting Accounting Series Release No. 177, the SEC conducted hearings that included consideration of the auditor's involvement with interim financial information. Partially as a result of the SEC's consideration of the subject, the AICPA issued Statement on Auditing Standards No. 10, *Limited Review of Interim Financial Information* (December 1975) (AICPA, *Professional Standards,* vol. 1, AU section 720), on the extent of procedures, and Statement on Auditing Standards No. 13, *Reports on Limited Review of Interim Financial Information* (May 1976) (AICPA, *Professional Standards,* vol. 1, AU section 519), on the form of the report. (See section 10 for a more detailed description of the relationship between ASR No. 177 and SAS Nos. 10 and 13.)

The review we recommend would be part of the audit. However, the audit—and the assurance normally expected from an audit—would not be complete until after the close of the annual period. The objective of the review would be to obtain an understanding of the process used by the company to prepare financial information at interim dates and to evaluate the company's ability to prepare reliable quarterly information. Thus, it would include a study and evaluation of the controls over the accounting system pertinent to the preparation of quarterly financial information and a probing inquiry of the procedures used by management to make estimates and identify disclosures.

The reviews made each quarter would need to be coordinated with the audit of both the annual financial statements and the accounting system and the controls over it. The study and evaluation of controls would need to be more extensive than would be necessary if the auditor were associated only with the annual statements. The extension of the study and evaluation would be necessary, for example, because the auditor would be concerned with controls over the allocation of annual financial statement amounts to quarters rather than simply with the validity of the total amount. If the auditor's past experience with the company indicates that particular estimates or disclosures have caused difficulty in preparing reliable quarterly information, those areas should receive additional attention.

Procedures normally performed once a year, such as confirmation of accounts by mail with customers or counting assets, would not be required to verify amounts presented in quarterly information. Transactions and events not contemplated by the company's financial reporting process might later require adjustment of the quarterly information. Also, a review would not necessarily detect intentional circumvention of the company's process. However, procedures to verify amounts presented in annual statements would, of course, be required for the audit of the annual financial statements, and their timing should be coordinated with the review procedures.

The effectiveness of the review would be enhanced considerably if the auditor obtains an understanding of the company's budgeting system and compares the amounts for significant financial statement items budgeted annually and for each quarter with the results achieved and with corresponding amounts for preceding periods. The auditor should also be familiar with the company's earnings plan and should relate that plan to his knowledge of its annual and quarterly budgets and its operating activities. Inspection of brokerage reports on a company would be a useful means for the auditor to gain a better understanding of the relationship between a company's operating activities and management's expectations.

All these steps would have the additional benefit of improving the auditor's ability to fulfill his responsibilities for the audit of annual financial statements. For example, increased knowledge of a company's budget, earnings plan, and operating activities would assist him in evaluating the cumulative effect of the selection and application of accounting principles, as we have recommended in section 2.

The Commission has not attempted to further specify in detail the procedures that would be required for a review of a company's financial reporting process. That task should be undertaken by an authoritative body, such as the Auditing Standards Executive Committee. Some auditors may find that their view of the procedures for a review differs little from those they have adopted under SAS No. 10. Auditors are not in complete agreement on the extent of procedures required by SAS No. 10 because a limited review is a new service and experience will be required before the new service achieves a degree of standardization. So it is with the review recommended by the Commission. Greater specification of the extent of procedures will require the deliberation and experience of auditors.

Form of Timely Reporting

Traditionally, the auditor has used a written report to identify explicity the responsibility he intends to assume when he is associated with financial information.[27] The auditor's report states the opinion he has formed on the information, or that he has no opinion, and the nature and extent of the examination on which the report is based.

If the auditor's role is extended as the Commission has recommended, the continuing auditor will be associated with financial information issued by the company during the year. Consequently, the form and timing of reports that might be used to communicate the auditor's conclusions and the responsibility he assumes must be considered.

Ernest L. Hicks, a former chairman of the AICPA's Auditing Standards Executive Committee, has indicated the concerns of auditors about accepting continuing responsibility:

> Most CPAs do not want to have any such continuous responsibility. Our reluctance is rooted in a concern that investors will misunderstand the nature of our involvement and so will be led to place unwarranted reliance on the information released. And, perhaps understandably, we do not wish to have a responsibility that might extend to communications made without our knowledge.[28]

Thus, the method of reporting is important because the report must not lead users to misunderstand the auditor's responsibility or the quality of the information.

Types of Assurance. Since the auditor will be associated with information that he has not audited, he will not be able to give users the same type of assurance that he does on audited annual financial statements.

Under present audit reporting requirements, the auditor usually gives one type of assurance—an opinion based on an audit. The auditor may also be associated with information in two additional ways: He may report that he has made a review of the information or, if the extent of his work is extremely limited, he may only report that the financial statements are unaudited. For both additional forms of association, under present reporting requirements, the auditor must disclaim an opinion, must state the information is unaudited, and normally may not provide any explicit assurance. With the variety of information being offered to investors and other users, the Commission believes that users can be effectively served only by changing this approach to reporting.

As Hicks noted, many auditors believe that users will not understand the significance of different types of assurance. Indeed, that belief underlies the present requirements that generally prohibit assurance unless the information has been audited.[29] However, the financial reporting needs of users today are too diverse and complex to be served by one type of assurance.

The assurance provided by different forms of association is difficult for users to understand and for auditors to describe because it is now not possible to quantify or evaluate the difference in assurance provided by audits, reviews, or other forms of association. However, a simple ranking can be made. That is, an audit provides more assurance than a review, and a review more than other forms of association with unaudited informa-

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27. This discussion is confined to those reporting issues raised specifically by extending the auditor's role; other communication issues are considered in section 7.

28. Ernest L. Hicks, "Should the Attest Function Be Expanded?" in *Corporate Financial Reporting: The Benefits and Problems of Disclosure,* ed. D.R. Carmichael and Ben Makela (New York: AICPA, 1976), p. 136.

29. Exceptions to the general prohibition include letters for underwriters and certain special reports. (See Statement on Auditing Standards No. 1, section 518 [AICPA, *Professional Standards,* vol. 1, AU section 518].)

tion. Eventually, after experience is gained, it may be possible to determine the probabilities that the procedures in each form of assurance will detect various errors, omissions, or misrepresentations.

Under the Commission's proposal, the audit function will consist, as does the present audit, of several elements. For association with both annual and interim information the auditor will identify material weaknesses in the system of internal accounting control. Similarly, for annual and interim information, he will review the process by which the information is prepared. Once a year, as part of a continuing function, he will make a more complete examination of the annual financial statements and the related controls, although not necessarily at the same time. However, the audit procedures and related assurance will apply to an accountability process over time, rather than to a set of financial statements at a date.

Ideally, the level of assurance provided users over the period should be constant. The annual financial statements will benefit from the more complete examination, but that additional assurance arises from the performance of the audit function throughout the period. Thus, the new form of annual audit report proposed in section 7 includes the report on the annual financial statements as only one part. The report on interim or other information will refer to the same study and evaluation of internal accounting controls and to the same audit conducted throughout the year. Thus, the distinctions between audits and reviews should gradually become less significant and the lack of understanding of them, less of a problem.

However, our proposal cannot change the fact that the annual financial statements will be audited, while those at interim dates will receive less attention. The assurance provided on the financial information is variable during the period, and that will have to be made clear to educate users. The report on the interim information must make clear that it is a report on the audit function at an interim date. We believe that the concept is understandable and that users will recognize the meaning and value of the auditor's association with interim information during the year.

The Commission believes that the view that users will misunderstand varying degrees of assurance underestimates users' capabilities. According to this view, any time the auditor is associated with information, users will assume it has been audited. This conclusion is predetermined by present reporting requirements. If the only form of assurance given is an opinion on financial statements, then users have no opportunity to understand other types of assurance. In fact, as explained in section 7, the continued use of a standard report for several decades has probably encouraged users to regard the auditor's association with information as a stamp of approval. The only way users will become informed is for auditors to change the traditional approach to reporting.

Illustration of Timely Reporting by the Auditor. The following is an illustration of a report to be released with interim information that reflects the new approach to reporting we believe is required. The report emphasizes that the review applies to the process, and the assurance expressed relates to that process rather than to the interim information.

> *Interim Report of Independent Auditors*
>
> We have reviewed the process used by the XYZ Company to prepare the accompanying financial information for the three-month period ended March 31, 197X. This review is part of our audit of the XYZ Company's financial information, accounting system and the controls over it, conducted during the year. Our report on the independent audit function is issued annually, at the time the audited financial statements for the year are issued.
>
> A review of the process used to prepare quarterly information consists primarily of inquiries of management, analysis of financial information, and comparisons of

that information to information and other knowledge obtained in our audit of the preceding year.

The purpose of a review is to evaluate the process used by the company to prepare quarterly information. Our review disclosed no material weaknesses in the process and any adjustments or additional disclosures brought to our attention by our review procedures have been reflected in the accompanying information. This is an interim report on our audit, and the financial information covered is only part of an annual financial period. Subsequent information or events during the remainder of the year may require adjustments or additional disclosure which will modify this information.

Test Check & Co.
Certified Public Accountants

Prerequisites to Providing Timely Assurance. To provide assurance, as illustrated, when interim information is released, the auditor must have an audit base; that is, he should have a continuing relationship with the company. Normally, he should have audited the financial statements of at least the preceding period, and his audit should have included a comprehensive study and evaluation of the accounting system and the controls over it. When the auditor is appointed during the year, he may be able to provide this type of assurance if his audit has progressed sufficiently to provide an equivalent base.

APPLICATION OF THE FRAMEWORK TO OTHER PROPOSED EXTENSIONS OF THE AUDITOR'S ROLE

The implications of the Commission's recommendations can be understood more clearly by applying the framework the Commission has recommended to some other frequently proposed extensions of the auditor's role.

Current Releases of Material Information

A company whose securities are publicly traded must promptly announce material information that affects investors' decisions. The company must also report certain developments in a form filed with the SEC shortly after the events occur.[30]

The relationship of this type of information to the audit function is marginal. The company must report, but in contrast to the regular reporting responsibility for quarterly or annual release of information, the release of information is intermittent. Controls that can be established over the accounting system to assure the prompt reporting of such current events are extremely limited.

The company may seek the auditor's advice on the selection and application of accounting principles to a current event or transaction. For example, the auditor may be consulted on whether a merger should be accounted for by the pooling of interest method or by the purchase method. Public reporting based on a very limited degree of involvement would be inappropriate because it would unduly fragment the audit function. The main benefit of the auditor's greater involvement in the financial reporting process is the general improvement expected in the process rather than the prevention of all deficiencies in specific releases of information.

Other Annual Report Data

Annual reports and similar documents containing audited financial statements usually include other financial information. This information may include a financial highlights

30. See SEC Accounting Series Release No. 206, "Adoption of Amendments to Certain Forms and Related Rules," January 13, 1977.

section, management's analysis of changes in earnings, comments on the financial statements in the president's letter, and similar information.

There are no standards that stipulate what financial information—in addition to financial statements—must be included in annual reports to shareholders, but there are minimum requirements applicable to information when it is presented. SEC proxy rules require that charts, schedules, graphs, financial highlights, or similar information of a financial nature presented in an annual report cannot be presented in a more or less favorable light than information in the audited financial statements.

The requirement on other annual report data was adopted as a result of a special study of the SEC's policies in administering the securities acts.[31] The study included an appraisal of the annual reports of a random sample of 125 companies. It found that "where seriously misleading disclosures do occur, they are most frequently found in textual references made to, or condensed presentations of, the results of operations."[32] Thus, even though the financial statements may be presented in accordance with applicable standards, information outside the statements—information based on or interpreting the statements—may be misleading.

The auditor now has a responsibility to read the other information in an annual report, but the extent of his work and his responsibility for reporting on the information are too limited.[33] The Commission recommends an immediate extension of the audit function to other information in an annual report.

Disclosure of interpretive information outside the financial statements is likely to increase in importance. For example, present accounting standards for research and development costs create a greater need for a discussion of research projects by management. The auditor with a continuing relationship with a company is in a unique position to provide some degree of assurance on other information, even though this assurance must be more limited than his assurance on the financial statements.

The lack of explicit acknowledgement of the auditor's responsibility for other information in the annual report has the potential to create user confusion and is inconsistent with the concept of an audit function suggested by this Commission. The audit function should include regularly released financial information derived from the accounting system.

This information is often presented in a format that lacks the discipline of conventional financial statements, and it often includes management's interpretation of operating results. Financial reporting requirements should not force management to forfeit its right and obligation to interpret the results of operations. However, the user should be able to assume that differences between this information and the financial statements are confined to matters of interpretation.

Management has a responsibility for reporting other information as specified in the SEC's proxy rules. Much of the information is derived from the financial statements or the accounting system that produced them. The auditor's knowledge of the company's business and operations, its accounting system, and its policies is pertinent to an evaluation of the other information.

The auditor should extend his procedures to include a comparison of the other information with the information in the financial statements and his audit work papers. When

31. Securities and Exchange Commission, *Disclosure to Investors: A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts* (Chicago: Commerce Clearing House, 1969). This study is generally referred to as the Wheat Report.

32. Securities and Exchange Commission, *Disclosure to Investors,* p. 369.

33. The auditor's responsibility for other information is explained in Statement on Auditing Standards No. 8, *Other Information in Documents Containing Audited Financial Statements* (December 1975) (AICPA, *Professional Standards,* vol. 1, AU section 550).

necessary, he should recompute information stated in percentages or combined in a manner different from that in the financial statements. His report should include a description of the work performed and his conclusions, as illustrated in section 7. If the information is materially inconsistent with the financial statements or his knowledge of the company and its operations, he should request management to correct the deficiency or he should modify his report to describe the difference.

Financial Forecasts

There have been frequent suggestions that financial disclosure be expanded to include forward-looking information such as management's plans, budgets, expectations, or earnings and cash-flow forecasts.[34]

Even if disclosure of financial forecasts expands, considerable developmental efforts would be required before the information was comparable to other accounting information. For example, one academic accountant has noted that "corporate financial information has been standardized to a reasonable degree insofar as it deals with past or present events, but little attempt has been made to standardize the process by which information is forecasted."[35]

Of course, forecasted information must always be based primarily on opinions about the likelihood of future events that cannot be verified as can past transactions. However, if the process of preparing forecasts is standardized to the same extent as that for other accounting information, then similar reviews could be made of the process. The degree of standardization that would be required has so far not been approached. For example, standards would be required on the type of information to be used as input for the process and on recording and otherwise documenting that information.

Efficiency, Economy, and Effectiveness

The activities of the U.S. General Accounting Office in evaluating the efficiency, economy, and effectiveness of government programs have raised questions about the general applicability of such activities by auditors.[36] Could independent auditors make similar evaluations of the programs of corporations and report the results to the board of directors or the shareholders and creditors? Could these activities include evaluation of the effectiveness of social programs and related responsibilities of corporations, such as equal employment or environmental protection? If all of this is possible, should it be done?

To the extent that information bearing on the efficiency, economy, or effectiveness of corporate programs, including social programs, is produced by the accounting system and is required to be disclosed in public releases of financial information, the audit function should evolve to include it. Also, such audits of governmental units are expanding, but they do not involve the same considerations as those that affect corporate entities.

Whether separate evaluations of the degree to which a corporate activity is efficient, economic, or effective should be included in the audit function is a different question. The competence of independent auditors to evaluate the effectiveness of social programs has

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34. The SEC held hearings and proposed two substantially different approaches to incorporating financial forecasts in securities acts disclosures. See Securities Act Release No. 5581, April 28, 1975 (CCH Fed. Sec. L. Reptr., paragraph 80,167).

35. Ijiri, *Theory of Accounting Measurement,* p. 152.

36. Guidelines for conducting such audits can be found in United States General Accounting Office, *Standards for Audit of Governmental Organizations, Programs, Activities & Functions,* 1972. Guidance for independent auditors engaged by governmental units to conduct such audits can be found in Committee on Relations with the General Accounting Office, *Auditing Standards Established by the GAO: Their Meaning and Significance for CPAs* (New York: AICPA, 1973).

been questioned.[37] A comparison with the boundaries of the audit function, developed earlier in this section, leads us to the conclusion that these matters should not be added to the audit function.

Auditors are not trained in these areas at present, although they presumably could be. However, the main objection is the risk of incompatibility with the audit function. Financial information is one of the primary means used to evaluate management's performance in operating the entity. An objective evaluation of financial information cannot be made if the auditor is deeply involved in evaluating the effectiveness of decisions that affect performance.

The AICPA's Rules of Conduct already contain prohibitions against making management decisions when providing advice to management. Evaluating the effectiveness of management's decisions creates more serious conflicts with the audit function than does providing advice that management may consider in making a decision.[38] If the audit function were to include evaluation of management's business decisions, that responsibility would, in effect, be to second-guess management and would effectively make the independent auditor a shadow management. Many questions could be raised about the competence of auditors to perform this function and about its usefulness. However, its basic incompatibility with the function that is now usefully performed by independent auditors is sufficient grounds for rejection.

Boards of directors and others might find evaluations of management or corporate performance in certain areas to be useful and within the capabilities of auditors. However, we believe that they should generally not be provided by the company's independent auditor to avoid the risk of jeopardizing the audit function.

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37. For an extensive consideration of this issue, see Arthur L. Thomas, "Evaluating the Effectiveness of Social Programs," *The Journal of Accountancy* (June 1976): 65–71. Section 9 also discusses the difficulties of including such areas in the audit function.

38. This subject and consideration of other activities that might be incompatible with the audit function are explored in section 9.

7 The Auditor's Communication With Users

Evidence abounds that communication between the auditor and users of his work—especially through the auditor's standard report—is unsatisfactory. The present report has remained essentially unchanged since 1948 and its shortcomings have often been discussed.[1] Recent research suggests that many users misunderstand the auditor's role and responsibilities, and the present standard report only adds to the confusion. Users are unaware of the limitations of the audit function and are confused about the distinction between the responsibilities of management and those of the auditor.[2]

Prescribing remedies requires more than devising alternative wording for the auditor's standard report. It requires analyzing the auditor's communication process to determine its goals and searching for better ways to reach them. Some of the problems that supposedly concern communication are, in fact, disagreements about the auditor's responsibilities; they are considered elsewhere in this report. This section deals primarily with the means used by the auditor to communicate with users. However, it reflects the recommendations to clarify the auditor's responsibilities that are made in other sections.

MAJOR COMMUNICATION DEFICIENCIES

The auditor's standard report is almost the only formal means used both to educate and inform users of financial statements concerning the audit function. For the largest corporations in the country, an audit may involve scores of auditors and tens of thousands of hours of work for which the client may pay millions of dollars. Nevertheless, the auditor's standard report compresses that considerable expenditure of skilled effort into a relatively few words and paragraphs. The following is a typical example.

> *Accountants' Report*
>
> Haskins & Sells — February 11, 1976
> Certified Public Accountants
> 1114 Avenue of the Americas
> New York 10036
>
> General Motors Corporation, its Directors and Stockholders:
>
> We have examined the Consolidated Balance Sheet of General Motors Corporation and consolidated subsidiaries as of December 31, 1975 and 1974 and the related Statements of Consolidated Income and Changes in Consolidated Financial Position for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting

1. For example, see Joseph L. Roth, "Breaking the Tablets: A New Look at the Old Opinion," *The Journal of Accountancy* (July 1968): 63–67; and Paul Rosenfield and Leonard Lorensen, "Auditors' Responsibilities and the Audit Report," *The Journal of Accountancy* (September 1974): 73–83.

2. This research includes surveys by G.W. Beck, *Public Accountants in Australia: Their Social Role* (Ph.D. diss., University of Queensland, Brisbane, Australia, 1972); and T.A. Lee, "The Nature of Auditing and Its Objectives," *Accountancy* (England) 81 (April 1970): 292–96. Additional surveys by Marc J. Epstein, "The Corporate Shareholder's View of the Auditor's Report," 1976; and a survey on the auditor's standard report by Richard E. Ziegler are described in appendix B.

records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the companies at December 31, 1975 and 1974 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied.

Haskins & Sells

The Drawbacks of Standard Language

Audit reports originally were quite descriptive; and the auditor had considerable discretion in how to word them. The following auditor's report appeared in the first annual report of the United States Steel Corporation.

Certificate of Chartered Accountants

New York
March 12, 1903

To the Stockholders of the United States Steel Corporation:

We have examined the books of the U.S. Steel Corporation and its Subsidiary Companies for the year ending December 31, 1902, and certify that the Balance Sheet at that date and the Relative Income Account are correctly prepared therefrom.

We have satisfied ourselves that during the year only actual additions and extensions have been charged to Property Account; that ample provision has been made for Depreciation and Extinguishment, and that the item of "Deferred Charges" represents expenditures reasonably and properly carried forward to operations of subsequent years.

We are satisfied that the valuations of the inventories of stocks on hand as certified by the responsible officials have been carefully and accurately made at approximate cost; also that the cost of material and labor on contracts in progress has been carefully ascertained, and that the profit taken on these contracts is fair and reasonable.

Full provision has been made for bad and doubtful accounts receivable and for all ascertainable liabilities.

We have verified the cash and securities by actual inspection or by certificates from the Depositories, and are of opinion that the Stocks and Bonds are fully worth the value at which they are stated in the Balance Sheet.

And we certify that in our opinion the Balance Sheet is properly drawn up so as to show the true financial position of the Corporation and its Subsidiary Companies, and that the Relative Income Account is a fair and correct statement of the net earnings for the fiscal year ending at that date.

Price, Waterhouse & Co.

Certain forms of report gradually gained limited acceptance but at first were not mandatory. Early examples are the forms suggested in 1917 and 1929 by the Federal Reserve Board.[3]

Standardization. Standardization of the report developed because many auditors' reports were confusing. For example, comments on accounting measurements were not separated from comments on the scope of the auditor's examination, and there was often no clear expression of an opinion on the financial statements or a statement that an opinion could

3. Federal Reserve Board, *Federal Reserve Bulletin,* April 1917, and *Verification of Financial Statements,* 1929.

not be expressed.[4] Since 1933, the profession has supported the use of a standard report, variations from which an auditor could be called on to justify. The standard report adopted in 1933 was revised in 1939, 1941, and 1948. Some of the changes made were in anticipation of beneficial effects on auditors' liability.[5]

Although the use of standard language avoids meaningless differences in wording and encourages uniform quality in reporting, it changes the character of the report.

The Report as a Symbol. One effect of using a standard report is that as a person becomes familiar with its words, he tends to stop reading it each time he sees it. He relies on his memory of what it says and his impression of what it means and merely glances to see that it is included and that it does not contain a departure from the usual language, that is, an exception. The entire report comes to be interpreted as a single, although complex, symbol that is no longer read.[6]

The reader comes to rely on his implicit understanding of the nature of the audit function in interpreting the meaning and significance of an auditor's report rather than on the description of the audit function that is contained in the report. If a user is generally unfamiliar with the limitations of financial information and the audit function, he may tend to view the auditor's report as a seal of approval and place unjustified reliance on it.[7]

In any event, if a user has misconceptions about the audit function, an auditor's report that he does not read will not correct them. Auditors need to do more to assure that their reports are read, but users who intend to rely on the fact that financial statements have been audited should at least read the auditor's report on them.

The attempt to communicate separate messages becomes less successful as a reader becomes more familiar with the standard language. The reader might easily overlook minor modifications of the standard language in a report that appears to be about the standard length.[8]

That users interpret the standard report as a symbol has implications that should be considered in any effort to modify the language. Minor changes in the standard language would likely not be noticed and would probably be ineffective. However, major changes in the standard language and the size of the report would likely be noticed and could result in users achieving a better understanding of the work of the auditor—both the benefits it provides and the limitations to which it is subject.

Communication by Inference

The standard report apparently is intended to convey several separate messages. Some are stated explicitly: the name of the company; the names and dates of the financial state-

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4. See D.R. Carmichael, *The Auditor's Reporting Obligation: The Meaning and Implementation of the Fourth Standard of Reporting,* Auditing Research Monograph No. 1 (New York: AICPA, 1972), ch. 2.

5. For a history of the development of the auditor's standard report, see George Cochrane, "The Auditor's Report: Its Evolution in the U.S.A.," *The Accountant* 123 (November 4, 1950): 448–60.

6. Lee J. Seidler, "Symbolism and Communication in the Auditor's Report," 1976 (described in appendix B).

7. Based on a questionnaire survey of corporate shareholders, Marc J. Epstein concluded that shareholders "are looking for a seal of approval. They believe that if an auditor with a recognizable name has signed that name in the annual report the shareholders have received that seal of approval" (Marc J. Epstein, "The Corporate Shareholder's View of the Auditor's Report: Conclusions and Recommendations," June 1976 [described in appendix B]).

8. The requirement in Statement on Auditing Standards No. 2 that qualified opinions contain separate explanatory paragraphs was adopted, in part, to overcome this tendency (Statement on Auditing Standards No. 2, *Reports on Audited Financial Statements* [October 1974], paragraphs 32–34 [AICPA, *Professional Standards,* vol. 1, AU section 509.32–.34]).

ments covered; that an audit has been performed in accordance with generally accepted auditing standards; that the auditor tested the underlying data rather than examined all data; that the auditor's report is primarily a matter of opinion; that the information is presented in conformity with generally accepted accounting principles; and that the application of accounting principles to similar circumstances has not changed from one period to another. However, other messages must be inferred. The present report only hints that financial statements are representations of management, by referring to the auditor's examination and his opinion on the information. It only hints that accounting principles appropriate in the circumstances were used, by referring to fair presentation. And it only hints that the auditor used judgment in auditing, by referring to the tests the auditor considered necessary. An auditor's report should state its messages explicitly and not rely on users' inferences.

The Hazards of Technical Terminology

The present report uses a number of terms that are not in common usage and that are essentially auditors' words of art, such as "tests of the accounting records," and "present fairly . . . in conformity with generally accepted accounting principles." Their meaning in the context of the report may be unclear or ambiguous to average readers.

The use of technical terminology reflects the technical nature of accounting and auditing. Most disciplines involve complicated concepts for which practitioners develop terms that are often obscure to the uninitiated.

The users of the services of some disciplines have little need to understand their technical aspects. Accounting, however, requires considerable comprehension by users. The user must clearly understand the nature and limitations of accounting information to make informed decisions based on it. Communication with users of the technical complexities of the field is an unusual demand of accounting.

The auditor's communication problem is perhaps slightly less difficult than that of accounting. It would be possible for the auditor simply to say "O.K." or "Approved" on a set of financial statements. In the auditor's language, such an auditor's report would merely read "Clean Opinion." Indeed, as noted above, it appears that some users do regard the auditor's standard report in such a simplistic light.

However, if the auditor is to provide the user of financial statements with assurance that is less or is more complex than a pure warranty of accuracy, his report must contain a description that communicates to the user both his conclusions on the information and his basis for reaching them. Particularly in the recent past, the auditor has depended for that purpose on phrases such as those discussed above from his words of art. He has been less than successful in that attempt.

To compound the problem, at least one of the technical terms in the present auditor's standard report is vague and ambiguous not only to laymen but also to many independent auditors. Significant misunderstanding of the phrase "present fairly . . . in conformity with generally accepted accounting principles" was evidenced by a majority of respondents to a survey conducted in connection with our work,[9] and the phrase has been the subject of widely varying interpretations in the accounting literature.[10]

Any revision of the auditor's report should make clear that technical elements are

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9. The survey on the auditor's standard report is described in appendix B.

10. Statement on Auditing Standards No. 5, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report* (July 1975) (AICPA, *Professional Standards,* vol. 1, AU section 411), was issued to resolve differences in interpreting the phrase. Section 2 of this report further discusses the difficulties associated with the "present fairly" terminology.

involved in the audit function but should clearly describe the work of the auditor and his findings and avoid unclear technical terminology concerning details.

The Need for Additional Messages

Since the auditor's standard report was last substantially revised in 1948, the auditor's responsibilities have been clarified and expanded; but those developments have not been recognized in the reporting process. His responsibilities now extend, for example, to events that occur after the date of his report that might show that his report was in error,[11] to other information contained in documents that include financial statements on which he reports,[12] and in some cases to interim information issued between the dates of audited financial statements.[13] In section 6 we recommend further expansion of the auditor's responsibilities.

The acceptance and discharge of added responsibilities should be communicated by the auditor to the users of his work. The additional messages, for example, should cover internal controls, other information in the annual report, association with quarterly information, corporate codes of conduct, and meetings with the audit committee of the company's board of directors.

A NEW APPROACH TO REPORTING

The present means of communicating the work of the independent auditor to users has not kept pace with developments in auditing and the financial reporting environment. A new approach should be adopted.

A Report on the Audit Function

The auditor's role and responsibilities have expanded and will continue to expand. An auditor's report only on a set of financial statements, as now presented, is not sufficient to convey his role and responsibilities as they now exist or as they will evolve in the future. A report on the entire audit function is required to provide sufficient flexibility to convey the required information to users.

Effect of Revised Report on Users. If the auditor's report is expanded to provide information on the auditor's discharge of the entire audit function in the specific circumstances of the particular client, the tendency for the report to become an unread symbol will be reduced. That the total report looks identical in every case is what causes readers to regard it merely as a symbol. If standardized alternative phrases or paragraphs are used that change with the circumstances, we believe that users will devote greater attention to the content of the auditor's report, but the benefits of standardized wording will be retained.

Once the reader's attention is obtained, substantially more information can be communicated. In particular, with the differences in circumstances of companies—some having audit committees, some with internal auditors, some with policies on illegal or ques-

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11. Statement on Auditing Standards No. 1 (November 1972), section 561 (AICPA, *Professional Standards,* vol. 1, AU section 561).

12. Statement on Auditing Standards No. 8, *Other Information in Documents Containing Audited Financial Statements* (December 1975) (AICPA, *Professional Standards,* vol. 1, AU section 550).

13. Statement on Auditing Standards No. 13, *Reports on Limited Review of Interim Financial Information* (May 1976) (AICPA, *Professional Standards,* vol. 1, AU section 519). The exposure draft of the proposed Statement on Auditing Standards, *Unaudited Replacement Cost Information* (December 15, 1976), if adopted, will require auditors to be involved with unaudited replacement cost disclosures.

tionable acts, and so forth—the differences in the types of services and assurances given by auditors can then be communicated reasonably effectively.

Effect of Revised Report on the Legal Climate. The language in the present report has been interpreted in court decisions and has a known effect. One of the reasons that the auditor's standard report has not been changed for almost thirty years has been the concern that a revised report would carry unknown and possibly adverse legal consequences. For example, a former chairman of the AICPA Committee on Auditing Procedure (predecessor of the Auditing Standards Executive Committee) said that one of the considerations in revising the report was "not to increase our legal responsibilities as a result of the revision."[14]

However, an auditor's report that more explicitly describes the responsibilities assumed by the auditor and his findings would, if anything, improve the legal position of auditors. Courts rarely determine the auditor's duties solely by reference to the words in his report. The standards of the profession usually are determinative, although courts have gone beyond the standards when they were considered inadequate.[15] Nevertheless, by more precisely and unambiguously describing the audit function, a revised report could provide a setting more conducive for the courts to form their opinions based on a more knowledgeable view of the purposes and capabilities of the function. "To the extent that the *possibility* of misunderstanding by the user is reduced, so is the *likelihood* of unfounded claims' being asserted, and the *probability* of their being successful."[16] Furthermore, courts would be able more easily to reach an informed judgment on whether the expanded and varied auditor's report has informed users of the nature and limitations of the assurances provided by the auditor than by the short and unvarying report.

A Report by Management

At present, management is not required to report on the financial statements although it is responsible for the representations in them. It is incongruous that the party responsible for the representations does not have to acknowledge its responsibility and that the only report on the statements may be the auditor's.[17] That situation has led to the understandable but erroneous assumption by many users that the financial statements are the representations of the auditor rather than of management.

We encourage boards of directors (or official bodies, if necessary) to require the company's chief financial officer or other representative of management to present a report with the financial statements that acknowledges the responsibility of management for the representations in the financial information. The report should provide management's assurances that the information is presented in conformity with generally accepted accounting principles appropriate in the circumstances and that all material uncertainties have been appropriately accounted for or disclosed. It should indicate that the company's legal counsel has been consulted regarding the accounting for or disclosure of legal matters and that those matters have been properly disclosed in the financial statements.[18]

The report by management should present management's assessment of the company's accounting system and controls over it, including a description of the inherent limitations

14. Roth, "Breaking the Tablets," p. 64.

15. Henry R. Jaenicke, "The Impact of the Current Legal Climate on the Accounting Profession," July 1976 (described in appendix B).

16. Roth, "Breaking the Tablets," p. 64 (Mr. Roth was repeating a point made by the legal counsel of the Institute).

17. See section 1 for a discussion of the differing responsibilities of management and the auditor for the representations in the statements.

18. See section 5 for a discussion of assurances by the company's legal counsel.

of control systems and a description of the company's response to material weaknesses identified by the independent auditor. It should describe the work of the company's audit committee and its internal auditors. As discussed in section 9, the first report by management following a change in independent auditors should disclose the change in a manner similar to that now required in SEC Form 8-K. The report by management should avoid purely subjective judgments designed to impress users with the quality of management.

Illustrations of the Direction of Change

Specific steps to improve communications with users will have to be accomplished through appropriate standard-setting bodies. They will have to monitor the system continuously to keep it current with developments in auditing. We cannot establish a revised system and keep it current, but we can illustrate the direction change should take.

Illustration of Revised Auditor's Report. The following is an illustration of an auditor's report that incorporates our recommendations. The illustration is based on the assumed adoption of many of the recommendations made throughout this report. The adoption of those recommendations would be made over a period of time, and thus the new elements of the report would not all appear at once. For example, substantial institutional changes would be required before auditors would be in a position to make the illustrated comment on illegal or questionable acts.

Report of Independent Auditors

The accompanying consolidated balance sheet of XYZ Company as of December 31, 1976, and the related statements of consolidated income and changes in consolidated financial position for the year then ended, including the notes, were prepared by XYZ Company's management, as explained in the report by management.

In our opinion, those financial statements in all material respects present the financial position of XYZ Company at December 31, 1976, and the results of its operations and changes in financial position for the year then ended in conformity with generally accepted accounting principles appropriate in the circumstances.[19]

We audited the financial statements and the accounting records and documents supporting them in accordance with generally accepted auditing standards. Our audit included a study and evaluation of the company's accounting system and the controls over it. We obtained sufficient evidence through a sample of the transactions and other events reflected in the financial statement amounts and an analytical review of the information presented in the statements. We believe our auditing procedures were adequate in the circumstances to support our opinion.[20]

Based on our study and evaluation of the accounting system and the controls over it, we concur with the description of the system and controls in the report by management. [or, Based on our study and evaluation of the accounting system and controls over it, we believe the system and controls have the following uncorrected material weaknesses not described in the report by management: . . .] [or other disagreements with the description of the system and controls in the report by management] [or a

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19. The term *fairly* and the reference to consistency have been omitted. See the discussion on the hazards of technical terminology in this section and a discussion of the term *fairly* in section 2. Section 2 also explains the auditor's responsibilities in connection with the appropriateness of principles in the circumstances. The confusion of responsibilities concerning reporting on consistency is explained in a later part of this section (7).

20. See the discussions of communication by inference and the hazards of technical terminology in this section.

description of uncorrected material weaknesses found if there is no report by management.] Nevertheless, in the performance of most control procedures, errors can result from personal factors. Also, control procedures can be circumvented by collusion or overridden. Furthermore, projection of any evaluation of internal accounting control to future periods is subject to the risk that changes in conditions may cause procedures to become inadequate and the degree of compliance with them to deteriorate.[21]

We reviewed the information appearing in the annual report [or other document] other than the financial statements, compared it to the statements, and found no material disagreement between them.

We reviewed the process used by the company to prepare the quarterly information released during the year. Our reviews were conducted each quarter [or times as explained]. [Any other information reviewed, such as replacement cost data, would be identified.] Our reviews consisted primarily of inquiries of management, analysis of financial information, and comparisons of that information to information and knowledge about the company obtained during our audits and were based on our reliance on the company's internal accounting control system. Any adjustments or additional disclosures we recommended have been reflected in the information.[22]

We reviewed the Company's policy statement on employee conduct, described in the report by management, and reviewed and tested the related controls and internal audit procedures. While no controls or procedures can prevent or detect all individual misconduct, we believe the controls and internal audit procedures have been appropriately designed and applied.[23]

We met with the audit committee [or the board of directors] of XYZ Company sufficiently often to inform it of the scope of our audit and to discuss any significant accounting or auditing problems encountered and any other services provided to the company [or indication of failure to meet or insufficient meetings or failure to discuss pertinent problems].[24]

Test Check & Co.
Certified Public Accountants

As illustrated, the revised auditor's report would consist of a series of paragraphs, each describing a major element of the audit function. The wording, or wording alternatives, for each paragraph would be standardized.

Some paragraphs would be omitted if not relevant to the circumstances of the company. Thus, the paragraph discussing association with interim information would apply only to public companies that send such information to shareholders. The paragraph on internal control would be omitted if the report by management did not deal with internal control and the auditor found no material uncorrected weaknesses in internal control.

For most topics, however, the auditor will be required to comment, negatively or positively. For example, the auditor must always indicate his opinion, or that he has no opinion, on the financial statements taken as a whole.

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21. See the discussion of reporting on internal control in section 6.

22. See the discussion of the need for additional messages in this section in connection with this and the preceding paragraph. The paragraph on quarterly information reflects our recommendations in section 6. Under present requirements in Statement on Auditing Standards No. 13, *Reports on Limited Review of Interim Financial Information,* the auditor must disclaim an opinion on the information when reporting on his limited review.

23. See section 5.

24. See section 9.

The wording of the paragraphs would depend on the circumstances. For example, a paragraph on illegal or questionable acts would differ depending on whether the company had a policy regarding those acts.

The report form illustrated is only a suggestion for the ultimate form; we do not present it as containing the precise wording the profession should use. The development of standardized paragraphs (and alternatives) will require a great deal of consideration by authoritative bodies; thus, the work should begin as soon as possible.

Illustration of Report by Management. The following is an illustration of a report by management that incorporates our recommendations.

Report by Management

We prepared the accompanying consolidated balance sheet of XYZ Company as of December 31, 1976, and the related statements of consolidated income and changes in consolidated financial position for the year then ended, including the notes. The statements have been prepared in conformity with generally accepted accounting principles appropriate in the circumstances, and include amounts that are based on our best estimates and judgments. The financial information in the remainder of this annual report [or other document] is consistent with that in the financial statements.

The company maintains an accounting system and controls over it to provide reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition and that financial records are reliable for preparing financial statements and maintaining accountability for assets. There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. The concept of reasonable assurance is based on the recognition that the cost of a system of internal control should not exceed the benefits derived and that the evaluation of those factors requires estimates and judgments by management. The company's systems provide such reasonable assurance. We have corrected all material weaknesses of the accounting and control systems identified by our independent auditors, Test Check & Co., Certified Public Accountants [or, We are in the process of correcting all material weaknesses . . .] [or, We have corrected some of the material weaknesses but have not corrected others because we believe that correcting them would cost more than it is worth.]

The functioning of the accounting system and controls over it is under the general oversight of the board of directors [or the audit committee of the board of directors]. The members of the audit committee are associated with the company only through being directors. The system and controls are reviewed by an extensive program of internal audits and by the company's independent auditors. The audit committee [or the board of directors] meets regularly with the internal auditors and the independent auditors and reviews and approves their fee arrangements, the scope and timing of their audits, and their findings.

The company's legal counsel has reviewed the company's position with respect to litigation, claims, assessments, and illegal or questionable acts; has communicated that position to our independent auditors; and is satisfied that it is properly disclosed in the financial statements.

The company has prepared and distributed to its employees a statement of its policies prohibiting certain activities deemed illegal, unethical, or against the best interests of the company. (The statement was included in the 197X annual report of the company; copies are available on request.) In consultation with our independent auditors we have developed and instituted additional internal controls and internal audit procedures designed to prevent or detect violations of those policies. We believe

that the policies and procedures provide reasonable assurance that our operations are conducted in conformity with the law and with a high standard of business conduct.

[If applicable—The Board of Directors of the Company in March 1976 engaged Super, Sede & Co., Certified Public Accountants, as our independent auditors to replace Test Check & Co., following disagreements on. . . . Test Check & Co. agrees with that description of disagreements.]

I. M. True
Chief Financial Officer[25]

Developing an appropriate standardized format will require considerable work. Substantial cooperation will be required between auditors and management (similar to the cooperation now devoted to wording notes to financial statements) to prepare reports that indicate management's responsibilities and to which the auditor can refer in his report. However, the independent auditor might sometimes find it necessary to comment on or take exception to elements of the report by management.

ADDITIONAL RECOMMENDATIONS ON COMMUNICATION

A number of other problems involving communication require solution, and they can best be solved at the time a new approach to reporting is adopted.

Confusion of Responsibilities Concerning Reporting on Consistency

A large part of the auditor's role is to evaluate whether the financial information presented meets appropriate standards. He should not originate financial information, report financial information in his report (except to make up for management's failure to make required disclosures), or interpret the significance of financial information presented for past performance or future prospects. For example, a discussion and analysis of changes in earnings is useful, but it should be presented by management, not by the auditor; the auditor should read it and consider it in relation to what he has learned from his total relationship with the client and take action if there are material misstatements or material inconsistencies with the audited financial statements.

One of the messages communicated by the present auditor's standard report, however, requires the auditor to originate rather than evaluate financial information in accordance with established standards. The auditor is required to state whether accounting principles have been applied on a basis consistent with that of the preceding year and, if an accounting principle has been changed, call attention to the change in his report.[26]

However, generally accepted accounting principles now require management to disclose in the financial statements that an accounting principle has been changed. When the requirement to report on consistency was established in 1933, accounting methods and disclosures concerning accounting changes were diverse. Accounting Principles Board

25. The inclusion of reports by management, which we think should be required, is beginning to develop in practice. For example, the annual reports of the American Telephone and Telegraph Company for 1975 and 1976 include reports by its vice president and controller that contain some of the elements we recommend for a report by management.

26. In section 3 we discuss the present requirement for the auditor to report on rather than evaluate information on unusual uncertainties. That requirement also places the auditor in the position of disclosing information in his report that is disclosed in the financial statements. In section 3 we recommend elimination of the present requirement for the auditor to report on uncertainties.

Opinion No. 20, adopted in 1971, now specifies the accounting and disclosures to be provided in the financial statements. The Opinion indicates the treatment in current and prior period statements, pro forma calculations that may have to be disclosed in the financial statements, and disclosures required in the financial statements concerning the nature of and justification for the change.

If the accounting and disclosure requirements have been met, the auditor should not have to report that the basis has remained unchanged or has changed.[27] If he reports no change or reports a change, he has crossed the line from evaluator of financial information based on established standards to originator of financial information.[28]

In sum, generally accepted accounting principles now make reporting on consistency management's, not the auditor's, responsibility. The auditor's proper function is to consider the propriety of management's accounting for changes in accounting principles and the adequacy of management's disclosures concerning consistency in the application of accounting principles, not to report that accounting principles have or have not been consistently applied. The illustration of a revised auditor's report in this section omits reference to consistency.

The Commission, however, recognizes that users currently receive significant, if sometimes incomplete, information efficiently through the highlighting of changes in accounting principles in the auditor's report. Therefore, to facilitate implementation of the recommendation to eliminate the auditor's reference to consistency, another useful change would be for the Financial Accounting Standards Board to amend APB Opinion No. 20 to require a standard note to the financial statements covering accounting changes. The note should disclose all changes that materially affect interperiod comparability, including both changes in accounting principles and changes in accounting estimates.

Obscured Responsibility Concerning Use of the Work of Another Auditor

Present auditing standards permit an auditor to refer to the examination by another auditor of the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.[29] The standards require the reference to disclose the magnitude of the portion of the financial statements examined by the other auditor and to indicate that the auditor's opinion on that portion is based solely on the report of the other auditor. If more than one other auditor is involved, their involvement may be stated in the aggregate. The other auditor need not be and usually is not identified, except in filings with the SEC. The auditor is required to make inquiries concerning the professional reputation and independence of the other auditor and to assure coordination of his activities with those of the other auditor concerning matters affecting consolidation or combination of accounts in the financial statements; he may sometimes employ additional procedures.

The following example (p. 82) is typical of an auditor's report in which reference is made to the work of other auditors as required by generally accepted auditing standards.

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27. Generally accepted auditing standards presently require the auditor's report to "state whether such principles have been consistently observed in the current period in relation to the preceding period" (Statement on Auditing Standards No. 1, section 420.01 [AICPA, *Professional Standards,* vol. 1, AU section 420.01]). Our recommendation would make it necessary to eliminate that requirement.

28. A large majority of respondents to the survey on the auditor's standard report by Richard E. Ziegler indicated their (erroneous) belief that the auditor's reference to consistency means that an accounting principle, once adopted, would be applied consistently thereafter.

29. Statement on Auditing Standards No. 1, section 543 (AICPA, *Professional Standards,* vol. 1, AU section 543).

Accountants' Report

Board of Directors
The Black and Decker Manufacturing Company
Towson, Maryland

We have examined the consolidated statements of financial condition of The Black and Decker Manufacturing Company and subsidiaries as of September 28, 1975 and September 29, 1974, and the related consolidated statements of earnings, changes in stockholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of certain consolidated subsidiaries located outside the United States which statements reflect total assets and revenues constituting 32% and 39% in 1975 and 27% and 32% in 1974, respectively, of the related consolidated totals. These statements were examined by other independent accountants whose reports thereon have been furnished to us and our opinion expressed herein, insofar as it relates to the amounts included for these subsidiaries, is based solely on the reports of the other independent accountants.

In our opinion, based upon our examinations and the reports of the other independent accountants, the financial statements referred to above present fairly the consolidated financial position of The Black and Decker Manufacturing Company and subsidiaries at September 28, 1975 and September 29, 1974, and the consolidated results of their operations and changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Ernst & Ernst
Baltimore, Maryland
November 7, 1975

The indication of division of responsibility in this report conforms with generally accepted auditing standards, but the standards are inadequate. The auditor gives an unqualified opinion on the financial statements but does not take full responsibility for the basis of his opinion. No other auditor need be named or need publicly acknowledge responsibility. The user cannot know the degree of assurance he should derive from the auditor's report. Some auditors' reports have included references to examinations by other auditors of portions of the financial statement items that exceeded 90 percent of the totals. If a large portion of the financial statement items are involved, the user may justifiably feel that responsibility for the audit of the consolidated statements is in a no-man's land.

The Commission recommends that the present method of referring to other auditors be eliminated. Two means are available to provide users with sufficient information on the responsibilities taken. Established standards now provide one option: The auditor can do enough additional work so that he does not need to refer to the other auditor. The additional work includes, for example, visiting the other auditor and discussing his procedures and findings, reviewing the other auditor's audit programs, and reviewing the work papers of the other auditor.[30]

Another option is to require management to present the reports of the other auditors of material components of the financial statements. If the other auditors' reports are not included, the auditor would take exception to the adequacy of disclosure.

30. Statement on Auditing Standards No. 1, section 543.

Inconsistent and Uninformative Reporting on Unaudited Information

Financial statements or information in the statements is called "unaudited" if the auditor has not examined them in accordance with generally accepted auditing standards but is nevertheless associated with them.[31] Such information includes both financial statements presented separately and information that appears in a document that contains audited financial statements, either as separate statements or as information labeled "unaudited" in the notes.[32]

Diverse information and responsibilities are forced into a single mold by a term that says what the information is *not*—not audited—and what the auditor does *not* do—does not audit. Furthermore, the auditor's reporting responsibilities for unaudited financial statements presented separately are inconsistent with, and more onerous than, those for unaudited information in a document containing audited financial statements. The auditor is required to make an affirmative statement that he has not audited the financial statements presented separately and to disclaim an opinion. In contrast, in a document containing audited financial statements the auditor is not required to mention unaudited information unless his knowledge leads him to have reservations about it.[33]

The reporting requirements should be made consistent, by requiring the auditor to report on all unaudited financial information with which he is associated, including that appearing in a document containing audited financial statements. Furthermore, it is unreasonable to expect users to make distinctions among different kinds of information all simply labeled "unaudited" but on which the auditor performs a wide variety or work.[34] Users should be informed about the work done and the assurances intended rather than merely about the audit that is not done.[35] The varying levels of assurance provided by the auditor and methods of informing users of the levels of assurance provided are discussed further in section 6.

Identification of the Auditor and Communication With Interested Parties

Other innovative means should be explored to educate and inform users of financial statements concerning the audit function. For example, we have received suggestions for improvements in communication between the auditor and interested users of the audited financial statements, including a suggestion for disclosure in the auditor's report of the name of the partner in charge of the audit. Knowledgeable creditors frequently request

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31. *Association* is a technical concept that governs whether an auditor has any responsibility for information. Statement on Auditing Standards No. 1, section 516.03 (AICPA, *Professional Standards,* vol. 1, AU section 516.03), specifies the circumstances in which an auditor is associated with financial statements.

32. Examples of unaudited statements sometimes appearing in a document containing audited financial statements are financial statements of prior periods and interim financial statements included in registration statements filed with the SEC. Examples of information sometimes labeled "unaudited" in the notes to financial statements are interim financial information, financial statements of investees carried at equity, and subsequent-event information.

33. The auditor is required to indicate that he has not audited prior-period unaudited financial statements appearing in certain documents containing financial statements he has audited if that fact is not disclosed in the financial statements. See Statement on Auditing Standards No. 15, *Reports on Comparative Financial Statements* (December 1976) (AICPA, *Professional Standards,* vol. 1, AU section 505).

34. See, for example, Alan J. Winters, "Unaudited Statements: Review Procedures and Disclosures," *The Journal of Accountancy* (July 1976): 52–59.

35. The body that sets auditing standards should deal directly with this recommendation as it relates to unaudited information that appears alone. Section 10 of this report contains recommendations on setting standards for the preparation of unaudited financial statements.

and often obtain contact with the partner in charge of audits of present and potential borrowers. Auditors frequently attend the annual meeting of shareholders and sometimes respond to questions on various matters.

If contact between the auditor and users is deemed valuable by the users, such added communications should be encouraged, considering the difficulties in the limited communication available through the auditor's report.

However, there are substantial implementation difficulties. Requirements for extensive personal communication with users could become costly and time consuming, particularly since the contacts would be limited to the partner in charge of the audit. Moreover, the auditor probably has a good deal of "inside information," as defined in the securities acts. Even inadvertent nonpublic communication with groups of investors could form the basis for charges of violation of the inside information rules and restrictions.

Fulfilling the reasonable expectations of users for access to the auditor within the limitations imposed on such communication could be accomplished by a requirement that the auditor be present and available to answer questions at the annual meeting of the shareholders. The same requirement should apply to due diligence meetings, which are held before securities are issued. We recommend that companies and their auditors undertake to arrange and announce such auditor attendance.

8 The Education, Training, and Development of Auditors

Many new accountants find that their education did not adequately prepare them for the responsibilities that face them on graduation. Every year public accounting firms spend millions of dollars and large amounts of time training newly hired accountants, virtually all of whom have just graduated from college. For reasons based on fact or myth, a schism has developed between practicing accountants and academic accountants. Academics point to the practitioners' resistance to innovation, and practitioners contend that the academics are impractical. Those conditions point to some fundamental problems in the process of educating, training, and developing auditors.

THE ADEQUACY OF EDUCATIONAL PREPARATION FOR THE PROFESSION

Formal education has long been considered a necessary part of the preparation for the practice of public accounting. Accounting courses received early acceptance in universities as subjects of higher education mainly in schools of business administration. However, accounting has not been given full professional status within universities by the establishment of separate colleges such as those for law and medicine. The public accounting profession has been unable to rely to the same extent as other professions on formal education for the development of competence to practice. This has placed a greater burden on public accounting firms for conducting training and continuing education programs.

Status of Accounting Education in Schools of Business

Accounting education, including public accounting as a subordinate subject, has continued as part of education for business. In many business schools, particularly at the graduate level, this means that accounting is primarily a service subject in an environment that views education for business as education for business management. In these programs the faculty views its role as primarily preparing students for executive positions in corporate management. The historical position of accounting education as a component of business management education has had several effects on the academic foundation of the public accounting profession.

Effect on Faculty. The educational structure has significantly affected the development of the accounting faculty. As business schools developed increased status within the academic community, particularly during the 1960s, accounting faculty members saw their future advancement and success increasingly depend on concerns unrelated to those of the accounting profession.

The academic accounting community, which had a substantial concern with the profession and financial accounting in the 1930s, has moved in recent years principally to managerial accounting or financial analysis with a heavy mathematical emphasis. This tendency has been accentuated by the recent trend of business academics, including accounting faculty members, to obtain the Ph.D. degree directly after undergraduate work, without business experience. In many cases this career path precludes a CPA certificate because many jurisdictions require experience in audit practice. These academics tend naturally to be less interested in the profession.

Effect on Students. Since education for business management has been the focus of business schools, prospective independent auditors receive their first exposure to the nature of their future duties in an environment closely identified with corporate management.

Another effect on students arises from the academic community's inadequate understanding of the independent auditor's role. Graduates of universities are the primary source of talent for professions in the United States, and low academic acceptance and support could have an unfavorable effect on the supply and quality of talent available to the public accounting profession.[1]

Effect on Research. The attitude of a business school faculty toward the field of public accounting not only influences the attitude of students toward a career choice in public accounting, but also significantly influences the research performed in universities and the achievement of innovation and improvement in practice normally expected from research.

Current problems of immediate concern to practicing accountants have attracted little interest among academic researchers, and auditing—which represents the bulk of public accounting practice today—receives scant research attention in most business schools. Most of the accounting research now performed by academic accountants is related to either management or finance problems.

Public accounting practice does not have the visibility of either law or medicine in university education, nor has the academic accounting community made the kind of contributions to the development of the knowledge base and problem resolution that the legal and medical professions receive from their academic communities. The resulting influence on student career choice and the contribution of academic research to improvement in practice have been less than is desirable.

Lack of Professional Identity

Formal education does not now adequately prepare students to meet the demands and risks of professional practice.[2] Immediately after employment, new staff accountants must be assigned work that requires a professional attitude and professional diligence and that carries significant responsibilities. However, formal education furnishes students with little exposure to the types of strains and pressures that they will be immediately subjected to in practice, and at present it usually does not instill in them an appreciation of the legal and ethical obligations assumed by independent auditors.

In a word, new entrants to the profession lack professional *identity.* Professional identity for a public accountant requires a highly developed sense of dedication to a professional ideal, responsibility to users of financial information, and loyalty to the profession as a whole. A program of learning imbedded in a school that views its mission primarily as educating the student for business management is unlikely to produce in him a highly developed sense of identity as a member of the public accounting profession. Such a program provides little opportunity to expose students to the customs, traditions, philosophical issues, and pragmatic approach of the practice of the profession.

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1. Recent continued increases in the number of accounting students suggest that, at least for the time being, the strong job market for accounting graduates has outweighed the negative influence on the supply of future public accountants, but the effect on quality cannot be determined from those figures. (See *The Supply of Accounting Graduates and the Demand for Public Accounting Recruits* [New York: AICPA, 1976].)

2. In a survey of audit partners and staff conducted by Professor John Grant Rhode and sponsored by the Commission, over 44 percent of those in public practice believed their college education did not provide sufficient preparation for the auditing work assigned them when they started their careers. This belief was more prevalent among those from local rather than national firms. (The survey is described in appendix B.)

Entry-Level Training of Professional Accountants

Public accounting firms assume a substantial burden of entry-level training for new professional accountants. This burden has fallen more heavily on small firms than on large ones because economies of scale make large training programs less expensive per person than small programs. To alleviate the burden of those costs, smaller firms have sometimes joined together to provide training courses or have partly relied on courses offered by state CPA societies or the AICPA.

Not only are smaller accounting firms faced with potentially higher unit costs, but the extensive educational programs of the large firms have become potent recruiting tools as well. It has become increasingly difficult for the smaller firm to attract young accountants who appreciate the benefits of the education programs offered by the larger firms. For all firms, however, the initial training burden results in considerable costs in both resources and time.

The body of knowledge required for public accounting practice has been growing at a dramatic rate, and the difficulties of keeping abreast of important developments tax the energies of even the most diligent auditors. The responsiveness of formal educational programs to developing professional needs has been limited. Business schools have had little involvement in continuing education programs related to public accounting. Entry-level training in business schools is also slow to reflect current problems.

IMPROVING THE EDUCATIONAL PROCESS

Several possibilities exist for making educational programs more responsive to the problems and needs of the public accounting profession.

Professional Schools

The desirability of establishing separate professional schools of accounting within universities has received increasing attention in recent years.

Arguments For and Against Professional Schools. A number of arguments both for and against professional schools have been debated. Advocates of professional schools maintain that separate schools will increase the recognition and prestige of public accounting, lead to attraction of more and better students, and increase the incentive for academic researchers to contribute to the resolution of professional practice problems. They hold that separation from general management education would allow the development of programs more responsive to the needs of the profession.

Opponents of professional schools are concerned with achieving an appropriate balance between general education, general business courses, and more specialized professional training and the related problem of attracting qualified faculty members. Economics, corporate finance, law, management, mathematics, and computer science are an important part of academic preparation for professional accounting practice. The opponents believe faculty members qualified to teach such courses could not be attracted to teach in professional schools of accounting.

The opponents of professional schools are also concerned about the practical and economic problems of separate schools of accounting, such as the expected increases in administrative costs and reallocation of resources from schools of business to schools of accounting.

Whether the argued improvement in the recognition and prestige of accounting and control over curriculum will be realized and whether the problems of appropriate balancing of courses and faculty can be overcome cannot be determined with certainty in advance. However, the gradual and successful development of separate graduate professional

schools in law, medicine, and other fields suggests that such problems are capable of solution.

Instilling a Professional Identity. The importance of instilling in students an appropriate professional attitude and the need to expose them to the pressures and problems of public accounting practice during the formal educational process support the need for graduate professional schools of accounting similar to law schools.

The expanding body of knowledge in public accounting, the demands and risks of professional practice, and the required knowledge in allied fields and in liberal arts provide sufficient substance for a professional program similar to that provided by law schools. Also, the long-range future of the public accounting profession requires the development of an academic community with a professional orientation. The timing and length of the program, which should consist of graduate study, should be chosen today by the particular professional school; it may be a two- or three-year program after obtaining a bachelor's degree, a two- or three-year program after three years of general education for business, or some other variation.[3] However, a four-year liberal arts undergraduate program and a three-year graduate professional program, similar to that of the law, should be the long-term goal. That structure may be necessary to permit accounting to compete on an equal footing for students who make their career decisions after college graduation.

Of particular importance is the need for a separate identity for those embarking on a career in public accounting. Our review of major audit failures that have caused public accounting firms difficulty indicates that problems have resulted largely from the exercise of poor judgment under conditions of stress and pressure. Audit failures have not, for the most part, resulted from lack of knowledge of accounting or auditing pronouncements.[4] A professional school should prepare candidates more adequately for the strains and pressures unavoidable in the work of independent auditors. Such programs should include substantial elements of analysis of practice problems and should incorporate other materials designed to expose students to professional responsibilities as well as to the methods of practice.

Professional Society Affiliation for Academics

As noted earlier, an increasing number of teachers of accounting proceed directly through the educational process, without a period of experience. The cause of professional education is not helped by this trend. Nevertheless, present and foreseeable trends in education and the economics of obtaining the Ph.D. now required of an increasing number of faculty members suggest that the process will continue.

The net result is that an increasing proportion of accounting faculty members are not CPAs and, therefore, are not eligible for membership in professional accounting organizations such as state CPA societies and the AICPA. Consequently, those faculty members do not have regular contact with the public accounting profession—they are not aware of its needs and concerns, and they do not have the opportunity to participate in the development of the profession through the organizations that sponsor much of that development. This separation is costly to the profession, and in the future will be even more so, since it tends to accentuate the already unhealthy split between the accounting profession and the academic accounting community.

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3. The AICPA Board on Standards for Programs and Schools of Professional Accounting recommends, "As a minimum, the curriculum shall consist of at least two years of pre-accounting preparation and not less than three years of progressively more advanced professional level study." *Board on Standards for Programs and Schools of Professional Accounting: Discussion Draft* (New York: AICPA, 1976), p. 6.

4. The staff analyses of cases involving alleged audit failures are described in appendix B.

Therefore, we propose that the AICPA and state CPA societies develop a form of membership, such as associate membership, that will permit accounting educators who are not CPAs to take part in state society and Institute activities. Such membership, of course, would not confer the right to practice or to represent the holding of a CPA certificate. However, like the existing International Associate program of the AICPA, it would produce a vehicle for Institute activity and participation.

Appropriate criteria for such a membership should be developed. They might include membership on the faculty of an accredited institution of higher learning, a Ph.D. degree, and passage of the Uniform CPA Examination.

The Uniform CPA Examination

For many years a uniform CPA examination has been given throughout the country. The AICPA and the National Association of State Boards of Accountancy have continuously worked to make the examination responsive to changes in practice and to assure that the examination appropriately measures the qualifications of candidates to practice as CPAs at the entry level. The examination, however, is taken principally by recent graduates and, therefore, the level of the examination is limited by the level of the educational process. To the extent that professional schools of accounting produce more skilled graduates, the level of the examination can be commensurately advanced.

Subject to this limitation, however, the CPA examination has displayed considerable evolution and appears to be a reasonable measure of the qualifications for initial admission to practice.

Continuing Education

The CPA examination is substantially limited to testing entry-level competence. A public accountant, however, must continue his development throughout his career. The rapid changes in the profession, the increasing complexity of the business environment, and the growing demands of the public require that members of the profession keep informed of professional developments.

The profession has recognized the need for continuing education, and a number of states have already established mandatory continuing education requirements. A recent study by the National Association of State Boards of Accountancy showed that thirty-six states favor mandatory continuing education of public accountants, and over half that number have already adopted continuing education requirements.[5] Many states offer certificates recognizing the completion of prescribed study.

Continuing professional education is being studied and implemented by many groups in the profession, and we have no recommendations to make on this subject. We do, however, recognize the necessity for continuing education and endorse the profession's efforts in this area.

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5. *Status Report of Continuing Education Requirements by Region* (New York: National Association of State Boards of Accountancy, July 1, 1976).

9 Maintaining the Independence of Auditors

One of the main values of an audit to users of financial statements is increased confidence in those statements because management's representations as to its performance and stewardship are reviewed and reported on by someone independent of the control of management.

The public accounting profession has long recognized the importance of independence for auditors. The Rules of Conduct of the American Institute of Certified Public Accountants prohibit certain relationships with a client.[1] Generally accepted auditing standards include a standard that requires the auditor to maintain an attitude of independence.[2] The Securities and Exchange Commission has issued a number of Accounting Series Releases to define independence required under the securities acts.[3] Individual public accounting firms also have adopted various policies and procedures to help assure the independence of their partners and staff, some more rigorous than the requirements of either the AICPA or the SEC.

Nevertheless, in the private economy of the United States and most other countries, the independent auditor is selected and paid by someone affected by his work. Consequently, total independence is a practical impossibility. Attention, therefore, has focused on measures to help assure that auditors maintain a necessary degree of independence. Since independence is so important to the audit function, a variety of proposals have been made to strengthen it. This section of the Commission's report evaluates many of those proposals.

The proposals considered by the Commission fall into three general categories:

- Restricting services provided by public accounting firms that might be incompatible with the audit function.
- Protecting the auditor from management influence.
- Assuring that public accounting firms are managed in a manner that provides the necessary internal support for the independence of individual partners and staff.

A considerable portion of the Commission's research efforts applies to auditor independence. A major study of partners and staff members was undertaken to develop information on the performance, attitudes, and supervision of working auditors. The Commission's study of lawsuits and other proceedings against auditors yielded a considerable amount of pertinent information. Extensive discussions were held with working auditors, financial analysts, technical partners of accounting firms, and representatives of government agencies, particularly with the SEC. The research is described in appendix B.

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1. Rule 101 of the AICPA Code of Professional Ethics (AICPA, *Professional Standards,* vol. 2, ET section 101.01).

2. Statement on Auditing Standards No. 1 (November 1972), section 220 (AICPA, *Professional Standards,* vol. 1, AU section 220).

3. The Securities and Exchange Commission's rule on independence is Rule 2-01 of Regulation S-X. That rule is discussed in SEC Accounting Series Release No. 2 (May 6, 1937), No. 22 (March 14, 1941), No. 44 (May 24, 1943), No. 47 (January 25, 1944), No. 81 (December 11, 1958), No. 112 (August 12, 1968), and No. 126 (July 5, 1972).

The Commission's conclusions resulting from this study and review may be summarized briefly as follows:

- There is no evidence that provision of services other than auditing has actually impaired the independence of auditors. However, the belief of a significant minority of users that independence is impaired creates a major problem for the profession. Decisions on the other services offered and used should be made by individual public accounting firms and boards of directors of clients.
- The present relationship between management and the auditor needs to be modified substantially to provide more support for the auditor's independence.
- Management policies of accounting firms—particularly those related to pricing and the related pressures on staff to reduce time and costs—have a negative effect on the ability of auditors to remain independent and should be improved.
- Elements in the business environment such as arbitrary time deadlines affect the quality of the audit, place unnecessary stress on the auditor's independence, and should be changed.

As discussed in section 11, on the regulation of the profession, the Commission has concluded that the present structure of a private profession, regulated by a combination of private and governmental efforts including the courts and the SEC, does not require drastic change. Therefore, we rejected proposals to improve independence that involved substantial changes in the nature of the private profession and its relationships with its audit clients, such as governmental selection or payment of auditors.

RESTRICTION OF SERVICES INCOMPATIBLE WITH THE AUDIT FUNCTION

If one of two services performed for the same client significantly reduces the usefulness of the other service, those services are incompatible. For example, if a public accountant provides such extensive management services to an entity that he consciously or unconsciously begins to identify his own viewpoint with that of management, he will lose his effectiveness as an independent auditor. If users of the auditor's work *believe* that he has lost his objectivity, they will be unwilling to rely on his work and he will also lose his effectiveness as an independent auditor.

Types of Services

Most large public accounting firms are divided into an accounting and audit division, a tax division, and a management consulting division. The three divisions indicate the broad categories of service provided by public accounting firms. In this section, services other than auditing are referred to collectively as other services and individually as either management advisory services or tax services. However, in practice, the services do not fall neatly into these categories, and smaller public accounting firms often do not have separate divisions but provide at least some services in all three categories.

Tax services include tax return preparation, tax planning advice, and representation before the Internal Revenue Service; tax personnel are usually called on to assist auditors, while audit personnel sometimes prepare tax returns for audit clients.

Some management services are closely associated with accounting and auditing, such as advice on information systems, controls, data processing equipment, and cost accounting. Many public accounting firms, particularly large ones, offer other management services that are unrelated to accounting and auditing. The term *peripheral services* is often used to describe this type of management services. Examples of peripheral services are market

surveys, studies of factory layout, psychological testing, public opinion polls, and executive recruiting for a fee.

Accounting and audit services usually include a variety of work in addition to audits of financial statements, such as bookkeeping, preparing unaudited financial statements for companies not required to issue audited statements, special investigations of accounting information involving work less extensive than an audit, preparation of forms and reports required by industry associations and state or federal agencies, and advice on the selection and application of accounting principles and the accounting implications of proposed management decisions.

The Relationship of Other Services to the Audit Function

Before independent audits became widespread in the United States, public accountants were already performing a variety of other services. Public accountants in the early 1900s offered advice on accounting systems, kept accounting records, prepared financial statements and tax returns, and performed a variety of consulting services, including appraisals. Public accounting firms have continued to perform other services, often for the same companies that engaged them as independent auditors. Auditing dominates the practice of large public accounting firms, but it has never been the sole function performed by public accountants. In many smaller firms or smaller offices of larger firms, independent auditing contributes little to total fees.

The charge to this Commission, however, was to consider the responsibilities of independent *auditors*. Thus, we must view other services in light of their effect on the audit function, even though auditing may not be the principal function of some public accounting firms.

Auditing and other services unavoidably overlap. An audit of financial statements, for example, requires an evaluation of the adequacy of the company's liability for income taxes. The auditor's study and evaluation of internal control often results in the identification of material weaknesses in the company's controls and produces suggestions for improvements in the accounting system or the controls over it. Frequently, this type of advice evolves into a consulting engagement. Many consulting engagements involving information systems require consideration of the ability to audit the resulting records and reports. Particularly for services related to accounting systems, controls, and principles, a distinction between other services and auditing is difficult to make.

An audit requires considerable knowledge about a company, its operations, and its industry. Providing management advisory services for an audit client may increase the auditor's understanding and knowledge and prove advantageous in conducting the audit. The auditor also is better situated than other consultants to provide management services: He is known by management, and his knowledge of the company may make him more aware of consulting needs and opportunities.

The Management Services Controversy

A pronounced concern with providing management services to audit clients developed in the early 1960s when those services grew at a rapid rate. Since then, the AICPA has had two special committees study the problem. The first, the Ad hoc Committee on Independence (1969), considered only management services, and the second, the Committee on Scope and Structure (1974), considered all other services.[4] The AICPA's Ethics Division

4. Ad hoc Committee on Independence, "Final Report," *The Journal of Accountancy* (December 1969): 51–56; Committee on Scope and Structure, *Final Report* (New York: AICPA, 1974).

and Management Advisory Services Division have issued a number of pronouncements limiting the services that can be provided to audit clients.[5]

Many others—primarily college professors—have surveyed user groups, independent auditors, and corporate executives to determine the extent of concern with the effect of management services on independence.[6] The surveys have produced mixed and conflicting results, but generally they have shown that a significant minority of users are concerned about the potential conflict between management services and the audit function. The concern of users decreases as their familiarity with the nature of services offered by public accounting firms increases, and it diminishes substantially when the services are provided by different staff, such as a separate management services division.[7] In general, corporate executives and auditors are less concerned than users. All three groups generally believe management services cause a less serious conflict than other factors such as "flexible" accounting principles or payment of the audit fee by the client.[8]

That any large, although minority, segment of financial statement users views management services as potentially reducing the auditor's independence must be a cause for concern. If the views of the minority were supported by empirical evidence of loss of independence, prohibition of management services would be essential.

Evidence of Alleged Conflicts Associated With Audit Failures

Both AICPA committees that considered the issue concluded that prohibiting performance of other services for audit clients was neither necessary nor appropriate. They based their conclusions, in large part, on their failure to find evidence of impairment of independence after decades of the performance of other services for audit clients.

Nevertheless, one critic of the findings of both committees charges that evidence did exist. Professor Abraham J. Briloff states,

> There have been no cases reported, they say, where independence *in fact* had been impaired by the rendering of these peripheral services—or at least so the AICPA's Ad Hoc Committee on Independence asserted in its Report. . . . I cite the discernible conflicts at Yale Express, National Student Marketing, the Wall Street Back Office Mess, and Westec to refute the AIPCA's repeated assertion that there have been no reported cases of the conflict.[9]

Professor Briloff appears to be the only one who has cited cases to support the proposition that providing other services has resulted in a loss of independence. The Commission's

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5. Pronouncements of the Management Advisory Services Division dealing with independence of the auditor are Management Advisory Services Practice Standard No. 1 (AICPA, *Professional Standards,* vol. 1, MS section 110), and Statement on Management Advisory Services No. 3, *Role in Management Advisory Services* (September 1969) (AICPA, *Professional Standards,* vol. 1, MS section 430). Pronouncements of the Professional Ethics Division are Interpretation No. 3 of Rule 101 of the AICPA Code of Professional Ethics (AICPA, *Professional Standards,* vol. 2, ET section 101.04), and various ethics rulings on independence (AICPA, *Professional Standards,* vol. 2, ET section 191).

6. Abraham J. Briloff, "Old Myths and New Realities in Accounting," *The Accounting Review* 41 (July 1966): 484–95; Ronald V. Hartley and Timothy L. Ross, "MAS and Audit Independence: An Image Problem," *The Journal of Accountancy* (November 1972): 42–51; David Lavin, "Perceptions of the Independence of the Auditor," *The Accounting Review* 51 (January 1976): 41–51; Arthur A. Schulte, Jr., "Compatibility of Management Consulting and Auditing," *The Accounting Review* 40 (July 1965): 587–93; Pierre L. Titard, "Independence and MAS: Opinions of Financial Statement Users," *The Journal of Accountancy* (July 1971): 47–52.

7. Titard, "Independence and MAS."

8. Hartley and Ross, "MAS and Audit Independence."

9. Abraham J. Briloff, *More Debits Than Credits* (New York: Harper & Row, 1976), p. 283.

analysis of legal cases did not disclose any other examples and our survey of audit staff members failed to indicate any significant relationship between the provision of management services and substandard audits.[10] In addition, both AICPA committees that studied the issue, and one other researcher, Arthur Schulte, Jr., solicited evidence from a variety of groups without uncovering additional examples.

Demonstrated conflicts of interest—even if few in number—are important because of the damage they cause to the reputation of auditors and because they suggest the possible existence of more examples. If a few abuses lead users of financial statements to distrust the independence of auditors generally, the significance of those cases can vastly exceed their number. Therefore, these cited cases of alleged conflicts of interest must be analyzed.

The Nature of the Services Provided. In *Yale Express* the service provided was a review of the company's internal accounting procedures. It was undertaken because the president allegedly believed the company was doing better than was reflected in its financial statements and because he thought improvements were necessary in the accounting system to better measure operating results.

In *National Student Marketing,* the other service was the issuance of a "cold comfort letter" to underwriters in connection with a merger agreement. A cold comfort letter contains representations on the independence of the auditor, assurance on the conformance of financial statements with SEC reporting requirements, and a report on a limited review of unaudited financial information issued after the audited financial statements. A limited review consists of analysis and inquiry procedures and is considerably less extensive than an audit.

In the "Wall Street Back Office Mess," the other service was the design of information systems and consultation on their implementation. Many brokers and dealers in securities had inadequate systems, and public accounting firms were engaged to design new systems.

In *Westec,* the other service was advising on the accounting effect of prospective merger transactions and involvement in the company's merger and acquisition program.

The Alleged Deficiency on the Part of the Independent Auditors. In the first three cases cited, the auditors obtained information while providing the other services that reflected unfavorably on audited or unaudited financial information issued by the companies. Professor Briloff's view is that the independent auditors should have made prompt disclosure to the SEC, to the exchanges on which the companies' securities were traded, or to other regulatory agencies as soon as they were aware that the companies had issued deficient financial information or, in the case of brokers and dealers, that their accounting systems were not functioning properly.[11] The allegation is that the auditor did not use the information obtained in providing the other service to produce additional benefits in the audit function. That issue is valid and is further explored later, but it does not support the conclusion that other services weakened the audit function. To the contrary, it suggests that the performance of other services might strengthen the audit function by providing additional access to the client and hence additional information.

In the fourth case cited, *Westec,* Professor Briloff believes the independent auditor's intimate involvement in the acquisition program injected a bias in the judgment applied to the appropriateness of the accounting principles selected by management to account for the acquisitions.[12] This case seems more to the point: The provision of accounting

10. The staff analyses of cases involving alleged audit failures are described in appendix B.

11. Briloff, *More Debits Than Credits,* pp. 29–40, and *Unaccountable Accounting* (New York: Harper & Row, 1972), pp. 286–98.

12. Briloff, *Unaccountable Accounting,* pp. 85–86.

advice combined with involvement in the merger and acquisition program, it is alleged, reduced the ability to audit the resulting transactions with independence.

Discussion of accounting principles with management is an unavoidable part of the audit function. It is certainly not in the category of peripheral services. Nevertheless, setting aside the issue of the category of the service, experience suggests that giving advice on accounting principles, whether or not any other services are involved, can conflict with the auditor's other responsibilities. This issue is considered in more detail later in this section.

Relation of Other Services to the Audit Function in the Cited Cases. Suggestions for improvements in accounting systems and controls or advice on the accounting implications of management decisions have always been closely associated with accounting and auditing. They are an integral part of audit services. Separating them from the auditor's other responsibilities or prohibiting them would be difficult, if not impossible. However, as explained later, other safeguards are possible and necessary.

Comfort letters are also closely related to the audit function. The auditor of the annual financial statements is the only person who can provide representations about the audit of those financial statements,[13] and he is usually the only one with enough knowledge to conduct a limited review of unaudited financial information.[14] However, the issuance of comfort letters does involve an unusual level of risk to the auditor, a risk which would be reduced by adoption of the recommendations presented in section 6.

The Interest of Financial Statement Users in Other Services. Financial statement users should benefit if an independent auditor is involved with a client more extensively than is required for the year-end audit. The securities markets depend on reliable financial information issued on a timely basis. The auditor's early involvement in decisions that will ultimately affect the financial statements can improve the financial information issued during the year. In section 6 the Commission recommends greater involvement by the auditor in the financial reporting process and encourages a continuous relationship between the client and the auditor.

Users of financial statements should benefit if the independent auditor's increased knowledge from providing other services discloses deficiencies in financial information, serious weaknesses in a company's accounting system or controls, or otherwise provides insight essential to the effective performance of the audit function. Indeed, the aspect of the auditor's performance questioned by Professor Briloff is the failure to use information gained in providing other services for the benefit of financial statement users.

Prohibiting independent auditors from providing these services is not a sensible response, particularly in the absence of evidence of actual conflict or adverse consequences. If the independent auditors had not provided the services, they would not have faced any conflict about whether to disclose the information because they would not have acquired the critical knowledge gained by performing the other services. If the services were not provided, financial statement users would have had even less opportunity to acquire material information. Recommendations are made below for requiring disclosure of such information.

A Request for Additional Examples. Evaluation of these particular examples, however, is not conclusive. The Commission, therefore, solicits other examples in which respondents

13. Statement on Auditing Standards No. 1, section 630 (AICPA, *Professional Standards,* vol. 1, AU section 630).

14. Statement on Auditing Standards No. 10, *Limited Review of Interim Financial Information* (December 1975), paragraphs 13–18 (AICPA, *Professional Standards,* vol. 1, AU section 720.13–.18).

to this report believe that an auditor's independence was impaired by the performance of other services, or in which the potential risk of impaired independence is greater than the benefits provided. Respondents should provide as much information as possible.

The Special Case of Tax Services

The auditor's relationship to his client in providing tax services creates a potential conflict with the audit function. The audit function attempts to assure the presentation of *unbiased* financial information in financial statements. Financial information is also the basis of the client's federal tax return. However, the information in the tax return is expected to be accurate but *biased*. That is, all parties, including the U.S. Treasury, acknowledge the right of taxpayers to reduce their taxes to the minimum legally payable. The Internal Revenue Code provides considerable opportunities for the use and application of alternative accounting methods to reduce taxes, even when such methods are not permissible under generally accepted accounting principles. In many instances, the tax accounting devices were deliberately added to the Internal Revenue Code to induce specific economic actions, such as the purchase of capital equipment.

Tax Services and the Audit Function. Since the original enactment of federal income tax laws, accountants have provided advice on reducing taxes, often to audit clients. The tax laws generally do not require consistency between financial reporting to shareholders and tax reporting. (The use of the LIFO inventory method is the most notable exception.) Consequently, no legal conflict is involved in these differences, and in most instances they need not affect the unbiased character of the financial statements.

For financial reporting on and auditing of publicly held corporations, this potential conflict does not seem to have produced significant problems—after sixty years of experience with the federal income tax. None of the cases reviewed by the Commission indicated that the influence of advocacy in tax services had reduced the independence of auditors.

Tax advocacy appears to be a persistent problem with smaller, nonpublic businesses. Professional disciplinary actions are frequently involved in this area, and there is reason to believe that audited financial statements are sometimes presented on a tax basis but purport to be presented on the basis of generally accepted accounting principles. Clearly, this is a problem affecting independent auditing, a problem for which no immediate solution is in sight. However, it is also only one part of the total problem related to audits of smaller, nonpublic entities and does not appear to be amenable to analysis or solution when considered alone. Unfortunately, as noted in the introduction to this report, the Commission felt obliged to concentrate principally on issues associated with audits for companies whose securities are publicly traded. Consequently, this specific problem received no attention. Nevertheless, we believe that adoption of the Commission's suggestions in section 10 for a restructuring of the Auditing Standards Division will provide a vehicle for quicker solution of the problems associated with smaller clients.

Public Policy Aspects. The U.S. system is not duplicated in all other countries. In the United Kingdom, for example, chartered accountants provide tax advice to their clients but are constrained to act less as advocates and more as arbiters. If a tax declaration is accompanied by the audited financial statements of the company, the Inland Revenue will normally not conduct audits of the books and records of the taxpayer such as are considered routine in the United States. The reliance of the Inland Revenue on financial reporting profits places an additional burden on independent auditors in the United Kingdom.

There have been proposals from time to time in the United States that CPAs be associated with the tax return in a manner similar to that in the United Kingdom, somewhat

reducing their advocacy role in tax matters. It is suggested that the costs of tax collection would thus be reduced, and the status of CPAs possibly enhanced.

The Commission believes that the United States system has stood the test of time. In particular, and with reference to the charge to this Commission, there appear to be no significant cases in which tax advocacy by an independent auditor of a public company has compromised his independence in an audit. Nor is there evidence to support a conclusion that the Internal Revenue Service or the Congress would be willing to adopt the U.K. system. Therefore, the Commission recommends no change in this area.

The Special Case of Accounting Advocacy

There is a greater danger that independence may be impaired by advocacy in accounting matters than by advocacy in tax matters. "Accounting advocacy" refers to all circumstances in which an independent auditor is allied with a client to present a particular accounting viewpoint. Examples are contract renegotiation proceedings, testimony at regulated industry rate hearings, economic stabilization compliance, and antitrust or fair trade investigations.

There are two ways in which accounting advocacy may impair independence. Involvement in the development, presentation, or defense of a particular accounting issue may inject bias into the judgments required in the audit function. Second, the regulatory agency involved may believe that the auditor is acting as an independent agent in the advocacy matter, which may lend undue credibility to the specific work and eventually raise doubts about his independence in general.

A public accounting firm may serve many companies subject to similar accounting or reporting requirements (such as the economic stabilization regulations of the early 1970s), and it is natural for the firm to develop the ability to consult with its clients on these matters. In fact, while a few of the largest companies have the personnel to respond quickly to changes in regulatory controls, most companies must rely on outside experts to assist them in compliance. It would be unreasonable and contrary to public policy to preclude the auditor from assisting in these matters.

Similarly, experience with many clients in a particular industry may give the auditor a perspective on the industry's specialized problems that is shared by few others. In most regulatory cases, an independent auditor will have a view (perhaps similar to that of the company) as to what is best for the company, the industry, or the economy. Because of this, it is almost impossible to separate consultation and advocacy.

The issues surrounding accounting advocacy are complex, and a simple prohibition against accounting advocacy engagements might create more problems than would be solved. As suggested later, under the heading "Providing Advice on Accounting Principles," professional standards addressing the pertinent considerations of the auditor should be developed. The conditions that present the greatest danger to independence should be identified; auditors should decline any engagement that may bias the audit function. Also, in all advocacy engagements, the auditor should exercise care to make it clear to users that his work and opinions are not presented in his capacity as an independent auditor.

Executive Search Services and Placement

Some observers believe executive search services and personnel recruitment for clients are in conflict with the independent audit role. The concerns are generally based on a view that the auditors may have a vested interest in seeing that managers hired through them "work out," regardless of actual performance, or that, because the managers hired through the efforts of the public accounting firm are known to the auditors, the auditors may place unwarranted reliance on accounting representations made by such managers.

These views seem to have more substance when the individual involved is a former employee of the audit firm.[15]

The Commission believes there is a potential for conflicts arising from executive search and other personnel recruitment services. The fundmental problem, however, is the relationship between management and the public accounting firm, regardless of whether such persons were outsiders placed by a formal recruitment service of the audit firm or were, as is much more common, former auditors who obtained management positions with the assistance of their firm's placement group. It would be impractical for us to recommend that companies be prevented from hiring individuals who were previously employed by a public accounting firm. The public accounting profession has traditionally served as the training ground for a large proportion, perhaps a majority, of management accounting personnel. The adverse implications of this particular independence problem are easily outweighed by the benefits of the present manpower development structure.

Public accounting firms should, however, take measures to avoid the appearance of conflicts of interest. We believe that firms should not engage in employment recruiting or placement of individuals who would be directly involved in the decision to select or retain independent auditors. This would usually mean the public accounting firm would be precluded from recruiting or placing presidents and chief financial officers, directors, and those at comparable levels. However, adoption of the Commission's recommendations to strengthen audit committees and to have such committees take an independent role in the auditor's selection would enable public accounting firms to continue to offer recruitment or placement services for management positions below the board or board-entry level with fewer potential independence problems.

No Fundamental Change Is Necessary

The earlier discussion and analysis lead to an almost unavoidable conflict between theory and empirical evidence. There is little question that the provision of some other services to audit clients poses an obvious *potential* threat to the auditor's independence. This potential threat, at least theoretically, is entirely credible.

Public accounting firms have indicated that they make substantial efforts to avoid conflicts of interest. Such statements recognize the undeniable fact that a potential for such conflicts exists. However, this recognition and the efforts taken to avoid conflicts appear to have been successful.

Except for the *Westec* case, the Commission's research has not found instances in which an auditor's independence has been compromised by providing other services. Indeed, there are some cases that indicate performing consulting services may improve the audit function and benefit users. If the empirical evidence were the only consideration, the Commission's conclusion would be clear: The evidence contradicts the theory. No prohibition of management services is warranted.

Nevertheless, consideration must be given to the belief of a significant minority that some other services do impair the auditor's independence. The auditor's effectiveness, and ultimately his livelihood, depend on the *belief* of users in his integrity. Despite the lack of evidence to support the belief that other services compromise independence, the belief persists and, therefore, represents a continuing threat to the credibility of the independent auditor. We later suggest possible ways of dealing with this problem. On balance, the Commission concludes that the relevant facts do not support a prohibition against any particular services that auditors are now permitted to offer.

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15. Several cases, including *Escott* v. *BarChris,* have revealed instances of audit staff members accepting without support false accounting representations from client managers who previously had been employed by the audit firm.

This conclusion should not be taken to imply total satisfaction with the present situation. The persistence of the belief held by a large minority of financial statement users and other observers that management services may or do impair the auditor's independence remains and should be addressed by the public accounting profession. Some educational efforts, particularly in the form of disclosure of steps taken by firms to prevent conflicts of interest, may be of value. In addition, efforts should be made to inform users of the nature and extent of other services provided to particular audit clients.

While the Commission is not suggesting that any particular services should be eliminated, avoidance of certain services will improve the reality or the appearance of independence. Firms should not expand their offerings of other services without careful consideration of the tradeoffs involved.

We believe that informed choice should be the main determinant of the services offered by auditors. Users of financial statements and audit services also should consider the tradeoffs involved in obtaining audit and other services from the same public accounting firms. In particular, boards of directors should carefully consider whether they wish to engage their regular auditors for other services or retain other firms for such purposes.

Additional Safeguards Recommended

While our analysis of the evidence of conflict between the audit function and other services does not support prohibition of particular services, other than the limitation on placement and recruitment noted earlier, other safeguards do seem to be necessary.

Board and Audit Committee Involvement. The board of directors (or its audit committee) of a company whose securities are publicly traded should be aware of all the services provided to the company by the independent auditor. The independent auditor should take the lead in informing the board or audit committee of all the services provided to the company, the relationship of those services, or lack thereof, to the audit function, the fees for those services, and the fact that information acquired in providing the other services must be considered by the auditor in fulfilling his audit responsibilities.

An audit committee of the board of directors is ideally situated to evaluate the tradeoffs involved in having audit and other services performed by the same public accounting firm. Knowledge of active participation by the board or audit committee may lessen the concern of some users about potential conflicts.

Knowledge of Deficient Financial Information. Professional standards now recognize that an independent auditor has certain obligations when he later discovers that financial statements he audited and reported on were deficient at the time of issuance.[16] However, professional standards do not recognize any obligation of an independent auditor to users of financial information issued by audit clients with which the auditor is not publicly associated.

The following requirements should be added to the professional standards of independent auditors:

- If information acquired in performing other services indicates a material deficiency in unaudited financial information issued by an audit client, the independent auditor should persuade the client to correct the information or, failing that, assure that the necessary disclosure is made.

16. Statement on Auditing Standards No. 1, section 561 (AICPA, *Professional Standards,* vol. 1, AU section 561). This section was originally issued as Statement on Auditing Procedure No. 41, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (October 1969).

- Public accounting firms should establish policies and procedures to assure that knowledge gained from other services is made available to the partner in charge of the audit so that he can consider its implications for the audit function, including assuring that consulting personnel who are not CPAs are made aware of the public accounting firm's professional responsibility as independent auditors.

Providing Advice on Accounting Principles. Professional standards should be expanded to cover the provision of advice on accounting principles. Discussions with the client on the accounting implications of business decisions and the selection and application of accounting principles to new or unusual transactions are an integral part of the audit function. However, there are virtually no professional standards on this aspect of the audit function.

If a public accounting firm provides services which extend beyond providing advice on appropriate accounting principles—such as involvement with negotiations between the parties in a merger and acquisition program while providing advice on appropriate accounting for business combinations, as in the *Westec* case—the combination of services creates a potential conflict with the audit function. The advocacy position of the consultant is not compatible with the objective judgment required of the auditor on the same transactions.

Additional professional guidance is essential. Professional standards should identify appropriate considerations involved when providing advice on accounting principles in order to avoid activities which do, or appear to, jeopardize independence. For example, the auditor may provide advice on the accounting effects of several alternative arrangements for a particular proposed transaction, but he should be careful to avoid advice that, in effect, encourages a client to comply with the form of accounting pronouncements but to evade their substance. Independent auditors must remain alert to all potential conflicts to assure that their primary goal is an objective evaluation of the selection and application of accounting principles.

Disclosure of Other Services. As noted earlier, the concern of users that provision of other services impairs the auditor's independence decreases as their knowledge about the services increases. The best way to dispel concerns of any potential conflicts of interest is to disclose the facts. The proxy rules for publicly owned companies already require disclosure of the interests of management and others in certain transactions. The Commission recommends that public companies also disclose, in the proxy statements issued to shareholders that include selection or ratification of the election of independent auditors, information on the nature of other services provided to the companies by their independent auditors.

PROTECTING THE INDEPENDENT AUDITOR FROM MANAGEMENT PRESSURE

Effective performance of the audit function depends heavily on the judgments and actions of the individual independent auditor. The independent auditor in charge of an engagement is subject to a number of conflicting pressures. He is a member of a private profit-making firm that depends on fees from clients.

Performance of the audit requires a close working relationship with management. Management's actions, decisions, and judgments have a significant effect on financial statements, and the auditor must have an intimate knowledge of those matters to do an effective audit.

At the same time, the obligations created by the audit function may require the auditor to persuade management to present a measurement of earnings or disclose material

information that reflects unfavorably on its performance. Often, the independent auditor's task is to persuade people to do precisely what they do not want to do.

A variety of proposals to increase the individual auditor's ability to resist management pressure are considered in the following discussion. The proposals take many forms, but their common characteristic is a change in the nature of the relationship between management and the auditor that is expected to result in either increasing the auditor's discretion or decreasing that of management.

Transfer to the Public Sector

A sweeping change in the relationship between the auditor and management would be to have independent auditors approved, assigned, or compensated by a government agency or to have audits conducted by a corps of government auditors. Arrangements such as these were specifically rejected when the federal securities acts were adopted.[17]

Some government agencies have demonstrated their ability to conduct large-scale audits. For example, the performance of the General Accounting Office, the Internal Revenue Service, and various groups auditing government contractors is highly regarded. However, the federal government has also demonstrated an interest in financial information for a variety of purposes that are unrelated to the usefulness of information to users. Frequently, the government is involved in using accounting data for regulatory and litigation purposes. Administration and congressional actions on the investment tax credit have demonstrated that financial accounting information may be used by the government to accomplish economic or political objectives. Thus, while there may be some deficiencies in the independence of public accounting firms, it is not clear that increased government involvement would be free of similar difficulties.

As discussed in greater detail in section 11, the Commission has not identified any areas in which further regulation of the public accounting profession by government would be warranted either by the magnitude of deficiencies in present practice or by promise of future improvements. The same arguments apply to proposals to have auditors approved, assigned, or compensated by the government. Therefore, as indicated at the start of this section, we do not consider structural changes of this nature to be necessary or warranted.

Fee Relationships

That auditors are compensated by the companies whose financial statements they are expected to objectively examine has seemed an anomaly to some observers. One proposal to change this relationship is to compensate auditors from a pool of funds created by assessments against all audited companies or by taxes on securities transactions. This proposal misses the real issue—management's ability to threaten to change independent auditors. The process of appointing and changing auditors, rather than how the auditor is paid, should be the cause for concern. If the selection and retention of auditors are a function of independent members of the board of directors, payment of the fee by the client company will not create any independence problem. On the other hand, if management has complete freedom to change auditors, paying the auditors independently will be no improvement.

Some significant advantages are gained from having the auditor compensated by the company whose financial statements are audited. Management is in a position to reduce the cost of auditing by establishing effective internal accounting controls and, in general, by operating a well-disciplined accounting system. Requiring companies to pay the audit fee, therefore, gives them an added incentive to institute internal procedures to

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17. See J. Wiesen, "Congressional and SEC Expectations Regarding Auditors' Duties," December 1976 (described in appendix B).

produce reliable financial information. A poorly controlled accounting system exacts a penalty in the form of a higher audit fee.

The source of funds for paying the audit fee is not as important in maintaining independence as is the location of the power to select the auditor, approve fees, and change auditors.

Audit Committees and Boards of Directors

A requirement for companies to have audit committees or a majority of outside, independent board members has been suggested in connection with various proposals, including federal chartering of corporations, minimum federal standards for incorporation, and modification of the listing requirements of securities exchanges.[18]

Proposals to specify the composition of boards of directors and to redefine their duties and responsibilities involve issues of corporate governance that transcend the relationship between the auditor and management. Consequently, we make no recommendations on the precise methods that should be adopted to assure the independence of outside board members or to appoint audit committees.

Nevertheless, an audit committee composed of outside, independent board members is potentially the most effective method for monitoring and achieving some balance in the relationship between the independent auditor and management. It can mitigate any management tendency to influence the independent auditor to depart from professional standards. Audit committees, however, cannot function effectively unless they include competent, independent, and reasonably active outside members of the board. The important point is that the auditor should have direct access to a significant number of board members who are not part of management. Outside members of the board of directors are in a unique position to represent the shareholders' interest, to monitor the performance of management, to provide adequate support to the independent auditor, and to make changes within the organization.

Independent members of the board of directors should be responsible for recommending to shareholders the appointment of independent auditors and for evaluating the relationship between the auditor and management.

Audit Arrangements and Fees

Arrangements for the audit are now usually made between the corporate controller, or treasurer, and the partner in charge of the audit. The arrangements are sometimes ratified by the board of directors or the audit committee of the board.

To a fully competent and honest financial manager, the major result of the audit, a "clean opinion" on the company's financial statements, is of little direct value. It merely satisfies a requirement. If the financial manager has confidence in the quality of the financial statements he has prepared, he will appropriately attempt to purchase audit services at as low a price as is reasonably possible.

Of course, a manager obtains benefits from the audit in addition to the expression of the auditor's opinion on the financial statements, including advice and counsel on accounting problems and a degree of assurance on the functioning of the accounting system and the company's personnel. In some instances, especially in international operations, the independent audit may provide an economical alternative to corporate efforts at control. In these respects, the manager is a "user" of the auditor's services and

18. In December 1976, the New York Stock Exchange adopted a policy that, as a condition of listing and continued listing, each domestic corporation with common shares traded on the Exchange must establish an audit committee. Adherence to the policy becomes mandatory as of June 30, 1978 (William M. Batten, Chairman of the New York Stock Exchange, letter to officers of listed companies, January 6, 1977).

is in the best position to make an unbiased assessment of the tradeoffs between price and quality.

Nevertheless, the principal purpose of the audit is, in effect, an independent assessment of the financial manager's work. Here, the financial manager is obviously not in the best position to assess the tradeoffs that may be involved in decisions on the price versus the quality of the audit.

A board of directors, or its audit committee, has a different perspective. While the board members also have an interest in reducing the cost of the audit to the corporation, they are the duly constituted representatives of the principal beneficiaries of the audit, the shareholders of the corporation. The goal of retaining a useful degree of price competition among public accounting firms but at the same time permitting user consideration of price-quality tradeoffs is necessary. Its achievement is more likely if the principal cost-versus-quality decisions are made by the board or its audit committee rather than by management.

The audit of a large business organization involves considerable logistic complexities. Audit work is performed at many different locations throughout the year and often involves interaction with corporate internal auditors. Efficient scheduling is important and can significantly affect costs. It does not seem reasonable to expect the board of directors or its audit committee to be intimately involved with the details of this planning.

The Commission believes, however, that boards of directors or their audit committees should take an active enough role in the total arrangements for the audit to assure that cost-versus-quality decisions are made in a manner that does not sacrifice audit quality. The Commission's research suggests that time pressure generated by unduly low fees and by arbitrary deadlines are the most significant cause of substandard performance by auditors. Matters of fees and timing, in particular, should be carefully considered by the board or audit committee, in direct discussion with the audit partner.

Thus, the arrangements for the audit should be made with the auditor by both management and the board of directors. However, the final decisions should be based on board discussions with the auditor and should not be delegated by the board to corporate officers.

It is difficult to envision the form for mandatory implementation of these suggestions. However, they can be implemented voluntarily, just as the formation of most audit committees in the past few years was undertaken voluntarily. Both boards and auditors should adopt such policies immediately.

Scrutiny of Auditor Changes

The independent auditor is now vulnerable to management's ability to dismiss him, for example, when there is a disagreement on accounting principles to be applied or disclosures to be made. Management is then free to search for a more compliant auditor, if one can be found. Measures that increase the outside scrutiny of a change in independent auditors are likely to inhibit the tendency to apply pressure to the independent auditor by threatening dismissal. The Commission's recommendation on audit arrangements and fees should result in increased scrutiny of changes in auditors.

Two recent developments, which we endorse, will also increase the scrutiny of auditor changes. Professional standards now require an auditor considering acceptance of a new client to consult with the preceding auditor to inquire, among other matters, about disagreements over accounting principles, disclosures, or the scope of the examination, and about facts that might bear on the integrity of management.[19] Forthright communica-

19. Statement on Auditing Standards No. 7, *Communications Between Predecessor and Successor Auditors* (October 1975) (AICPA, *Professional Standards,* vol. 1, AU section 315).

tion between a new auditor and the preceding auditor is essential. No refinement of professional standards can substitute for a sense of professional responsibility for open communication between auditors. The client's management can interfere by refusing to grant the preceding auditor the right to talk to the new auditor, but an independent auditor should refuse to accept an engagement in those circumstances.

A recent SEC regulation requires companies to report changes of independent auditors to the SEC and gives the preceding auditor an opportunity to explain disagreements with management within the preceding two years that concern accounting principles, disclosures, or the scope of the examination.[20] In addition, the SEC requires a company to disclose in its financial statements disagreements on accounting methods or disclosure if the new auditor agrees to accept a matter objected to by the preceding auditor that has a material effect on the financial statements.[21] This requirement should increase scrutiny of changes that occur when the independent auditor disagrees with management on a matter of financial statement presentation and strengthen the position of independent auditors.

Since increased scrutiny is desirable, the type of disclosure in financial statements now required by the SEC concerning disagreements when a change in auditors is made should be required for all audited financial statements.

In section 7 the Commission proposes that audited financial statements be accompanied by a report by management setting forth management representations related to the statements. The report by management should be a useful vehicle for disclosure of auditor changes. The Commission proposes that, when auditors are changed, disclosure comparable to that presently required by the SEC be included in the report by management which we anticipate would accompany all audited financial statements. The disclosure should appear in the first report by management issued after it is known that the auditor will not be retained.

Rotation of Auditors

Another frequently made proposal is to require companies to rotate independent auditors so that a new one is appointed every three to five years. Since the tenure of the independent auditor would be limited, the auditor's incentive for resisting pressure from management would be increased. Also, it is argued that a new independent auditor would bring a fresh viewpoint.

Rotation would considerably increase the cost of audits because of the frequent duplication of the start-up and learning time necessary to gain the familiarity with a company and its operations that is necessary for an effective audit. More important, in the Commission's study of cases of substandard performance by auditors, a high percentage of the problem cases were first- or second-year audits. While not conclusive, this indicates the higher peril associated with new audit clients. Once an auditor becomes well acquainted with the operations of a client, audit risks are reduced. If a relationship between audit failures and new clients does exist, rotation would increase the problem and be detrimental to users.

The problem of excessive competition between public accounting firms is discussed later in this section. Rotation would place a larger number of clients "up for grabs," which would appear to intensify competition.

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20. SEC Accounting Series Release No. 165, "Notice of Amendments to Require Increased Disclosure of Relationship between Registrants and Their Independent Public Accountants," December 20, 1974.

21. SEC Accounting Series Release No. 194, "Reporting Disagreements with Former Accountants: Adoption of Amendments of Requirements," July 28, 1976.

Many of the asserted advantages of rotation can be achieved if the public accounting firm systematically rotates the personnel assigned to the engagement. In section 6, the Commission recommends the development of continuous relationships and greater involvement of the independent auditor in the financial reporting process of clients. Some of the benefits expected from this type of relationship would be reduced by frequent rotation. Also, rotation would significantly increase the costs and difficulties of establishing effective continuous relationships.

Since the cost of mandatory rotation would be high and the benefits that financial statement users might gain would be offset by the loss of benefits that result from a continuing relationship, rotation should not be required. Weighing the relative costs and benefits of rotation is a task that should be undertaken by the board of directors or its audit committee. An audit committee is in the best position to inspect the personnel rotation plan of the independent auditor, evaluate its effectiveness, and decide, if appropriate, to rotate firms.

MANAGEMENT POLICIES AND PROCEDURES OF PUBLIC ACCOUNTING FIRMS AND THEIR EFFECT ON INDEPENDENCE

The management policies and procedures of public accounting firms can have an important effect on the independence of auditors. This section considers policies and procedures that are primarily concerned with the management of a public accounting practice. We review here aspects of the business environment that affect the independence of auditors. The more general subject of policies and procedures for controlling the quality of audits is considered in section 11.

Most of the Commission's recommendations concern actions that should be taken by public accounting firms. However, changes in client actions are also required in some areas.

The Effect of Competition on Independence

Members of the professions have long been presumed to compete principally on the basis of the quality of their services. Open price competition has generally been considered unprofessional, as have advertising and similar methods of attracting clients.

Recent court and regulatory decisions suggest that those attitudes toward professional conduct are not compatible with present social and economic beliefs. For example, lawyers have been enjoined from charging uniform rates for certain services and pharmacists in some states are now displaying prices of prescription drugs.

It is not lack of competition, however, but possible excessive competition that appears to present a problem to the public accounting profession today. The Commission's research on cases involving auditors and its survey of partners' and staff members' attitudes provide persuasive evidence that time and budget pressures frequently cause substandard auditing. Time pressures are often the result of unrealistic and unnecessary deadlines for completion of audits. However, there are substantial, sometimes destructive, pressures to reduce the total time to complete audits, without regard to particular deadlines.

The Commission has been unable to determine a single cause of time and budget pressures. The problem is multifaceted. We believe one probable cause is excessive price competition—that is, excessive competition among firms to offer lower fees—but the Commission has been unable to document this relationship. We made two attempts to undertake research on fee setting and negotiation practices, but the necessary information could not be obtained.

Nevertheless, the experiences of some members of the Commission and staff indicate that fee competition is common and increasing. Discussions with a few companies that have recently negotiated with new auditors indicated readiness on the part of public

accounting firms to offer competitive prices, to make bids with fees guaranteed for several years, to renegotiate prices after receipt of competitive offers, and to set billing rates at as much as 50 percent below normal. In a recent article in the *Wall Street Journal,* the managing partner of a large public accounting firm described the competition in public accounting practice and indicated his own firm's willingness to engage in intense competition.[22] A recently released congressional staff study includes a letter from one practitioner accusing another firm of unfair price competition.[23]

Excessive Competition: A Difficult Charge to Defend

A fundamental precept of the American economic system is that competition is good, and that more competition is better. Competition reduces prices and encourages efficiency, thereby improving the welfare of society. The federal government has pursued a policy of legislating against business arrangements or practices that reduce competition. Antitrust laws were enacted in the nineteenth century and have been continually broadened. Price fixing among suppliers is generally illegal under federal, state, and some local statutes.

The statement that too much competition might exist in public accounting initially seems difficult to sustain. Eight of the largest accounting firms audit 92 percent of the corporations listed on the New York Stock Exchange.[24] If that group is expanded to the twenty-five largest firms, it would include the auditors of virtually all publicly held companies and almost all large privately held companies. Also, the profession has prohibited advertising and similar forms of solicitation. Although the AICPA eliminated its stricture against competitive bidding several years ago, there still appears to be a situation suggesting too little competition rather than excessive competition.

Support for a conclusion that public accounting firms compete excessively first requires an acceptable definition of *excessive* competition in the face of a strong opposite presumption in United States society.

The Inability of Users to Evaluate Audit Quality Differences

As noted earlier, competition is desirable. However, if competition is to be useful to users of a product or service, users must have information that permits informed judgments about price, quality, and quantity. If competitors can conceal differences between products, the consumer has no basis for rational choices based on price differences. Consequently, the consumer may have to be protected when he does not have, or cannot obtain, adequate information on product attributes.

This idea is widely accepted in federal statutes.[25] These requirements restrict price and quality competition among producers to a defined and understood framework.

The consumer of an audit is the user of financial statements—a user who has limited ability to determine the quality of the audit and, therefore, the reliance that should be placed on audited information. Indeed, under present arrangements the user has no opportunity

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22. "Touche Ross Openly Strives for Growth as Accounting Firms Turn Competitive," the *Wall Street Journal,* October 5, 1976.

23. U.S. Senate, Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, *The Accounting Establishment: A Staff Study,* December 1976, p. 1729.

24. U.S. Senate, Subcommittee on Reports, Accounting and Management, *The Accounting Establishment,* p. 5.

25. For example, federal statutes require that the net weight or volume of the contents of a can of food be printed on its label, and ingredients must be listed in quantity order. There are federal grade standards for canned goods, meat, and other products. The reason for these requirements for packaged foods is that the consumer cannot ascertain product differences until after he has used the product.

to know, to consider, or to directly influence any tradeoffs made between price and quality.[26]

A research study for the Commission and extensive discussions with users indicate that users consider the name and reputation of the public accounting firm to be their principal source of information about the quality of the audit. Some users mistakenly extend their reliance to a belief that the auditor provides some guarantee of the financial health of the company. They should not be considered irrational. Users of financial statements presently have no knowledge of the quality of the financial information, the accounting and control systems that are the principal source of the information, or the price-setting arrangements made for the audit. Similar to users of many consumer products, the user of financial statements is left with little other than the "brand name" or the name and reputation of the public accounting firm as a basis for judging quality.

In the current structure, price competition takes place largely without user knowledge or control. Thus, the potential for destructive competition—degrading of quality that cannot be discerned by users—is high.

Existence of Competition Among Auditors

The number and structure of public accounting firms would be expected to affect competition. Most corporations whose securities are publicly traded are audited by a relatively few, large firms. With such a high degree of concentration, many users may not understand how there could be any degree of competition. However, there are conditions that create intense competition among large public accounting firms.

No Product Differentiation. When a product or service offered by different suppliers differs significantly to the user, or *appears* to differ significantly, it is easier for one of its producers to maintain a higher, noncompetitive price. Public accounting firms go to considerable lengths to develop superior services for their clients, but there is little effective product differentiation from the viewpoint of the present buyer of the service, that is, management of the corporation.

As discussed above, audit fees today are usually negotiated by financial officers of the corporation. The quality of the audit is of comparatively less concern to the financial manager. A "clean opinion" obtained from one reputable firm is about as valuable to the competent, honest financial manager as one from another reputable firm. On the other hand, a lower price—and possibly a more rapid audit—will improve the profits of the corporation and the position of the manager. Therefore, there are incentives for managers to be particularly price conscious, thus increasing the level of competition.

Elements of the Structure of the Accounting Firms Encouraging Competition. If the effective purchasers of the auditor's services are more conscious of price than quality, auditors will be tempted to compete on the basis of price and to make necessary adjustments in the extent of work performed. In addition there are elements in the American economy that affect the structure of the firms and the extent of price competition.

The publicly held companies whose audits are the principal concern of this Commission are typically large and complex, often operating in several industries and different countries. Regulatory requirements in the United States and abroad—the tax laws, regulations of the SEC and stock exchanges, government contracting requirements, the provisions of the Employee Retirement Income Security Act (ERISA), and currency exchange regulations, among others—along with the growing complexity of generally accepted accounting principles have expanded to the point that many specialists are required in public account-

26. A recommendation concerning fee negotiations is made earlier in this section.

ing firms. One or two large clients make it difficult to support the costs of such specialists. There are economies of scale in dealing with complexity. The need for specialists produces larger fixed costs that must be spread over a larger number of clients. Thus, competition to increase the number of clients—which we have already noted tends to be price competition—is encouraged.

Large corporations typically operate at a number of different locations. A public accounting firm must provide services at many places throughout the country and the world. In recent years, this pressure has encouraged the opening of offices in areas that were previously served by traveling personnel. Each new office becomes a new fixed cost center. Particularly in the early stages, there is pressure to increase the number of clients served by a new office. Classic economic analysis suggests that when the goal is to cover the overhead, competitors will be driven to marginal-cost pricing. That is, firms will offer their services at any price over their variable cost to make a contribution to fixed overhead. The Commission's discussions with representatives of public accounting firms and clients suggest that this is occurring.

Just as the opening of new offices encourages intense price competition, so too does the acquisition of clients in new industries. Different industries vary enough in complexity that public accounting firms tend toward industry specialization. If a client is acquired in one industry, there will be pressure to acquire additional clients in the same industry.

Competition With Smaller Firms. Most of the factors just described tend to exacerbate competition between large accounting firms. It might be expected that competitive forces would tend to be extended to competition between large and smaller firms, and indeed, this appears to be the case. Displacement—the frequent tendency of corporations to switch from smaller to larger public accounting firms as the corporations grow or become publicly held—has been recognized as a fact within the public accounting profession for many years. Displacement seems to occur for a number of reasons, although it has frequently been attributed to the preference of underwriters for public accounting firms well-known nationally. However, price competition also seems to be a factor, as indicated by the staff report of the Subcommittee on Reports, Accounting and Management.[27]

Large Firms, Concentration, and Independence

The staff report of the Subcommittee on Reports, Accounting and Management devotes substantial and generally unfavorable attention to the concentration of audits of publicly held corporations performed by a few large public accounting firms.

The virtues or vices of business concentration and the resulting pressures on smaller businesses in the United States are issues of public policy. They have implications that extend beyond the purview of accounting and auditing and the charge of this Commission. Consequently, the Commission has not given consideration to the implications of concentration for society.

The Commission has considered whether the concentration of business in several large firms has implications for the quality of auditing services received by users of financial statements and the cost of those services.

One of the principal vices attributed to business concentration is that it raises the costs to consumers when a small number of producers are able to keep prices at an artificial level. As discussed at length in this section of the report, there appears to be an intense, perhaps excessive, degree of price competition among large public accounting

27. U.S. Senate, Subcommittee on Reports, Accounting and Management, *The Accounting Establishment,* p. 45.

firms. Consequently, there is no reason to condemn concentration on the basis of costs to the users of financial statements.

More important would be the possibility that concentration might result in poor audits through a reduction in the need of a small number of suppliers to maintain quality. In the practice of auditing, there seems to be no evidence to support such a presumption. To the contrary, as discussed in greater detail in section 11, the larger public accounting firms appear to be making significant efforts to assure the quality of work performed. These efforts are intensifying rather than diminishing, as might be expected if concentration were excessive.

The recent congressional staff study indicated that a degree of industry concentration exists in auditing; that is, some public accounting firms audit a substantial proportion of the major companies in particular industries. Again, setting aside concern with national economic policy, it is difficult to discern how such concentration might be harmful to the exercise of the independent audit function. To the extent that such concentration promotes the development of greater industry expertise by the auditor, it is favorable. In recent years, public accounting firms with concentrations in certain industries have tended to publish and make widely available guides to accounting and reporting in such industries, a favorable development.

It is possible that the predominance of one firm in an industry could inhibit the development of accounting (not auditing) innovations. On the other hand, it would probably promote accounting uniformity in the industry. As a practical matter, management appears to exert the strongest role, particularly in larger corporations with greater accounting research resources, in the development of innovation in corporate financial reporting.

Concentration may also hold the promise of benefits to users. In industry, large producers may realize economies of scale unattainable by smaller units. Certainly, this characteristic has caused the growth of some big businesses in the United States.

There are economies of scale in public accounting related to the ability to deal more economically with the complexities of modern accounting, government regulation, and the business environment. More important, however, are the size of the public accounting firm as compared to the number of its clients, and the relationship to independence. When one or a few large clients supply a significant portion of the total fees of a public accounting firm, the firm will have greater difficulty in maintaining its independence. The staff study of the Subcommittee on Reports, Accounts and Management, for example, cites the case of a relatively small firm with a single client that represented 30 percent of the firm's total fees in the year 1973.[28] In the celebrated Equity Funding case, that company represented more than 40 percent of the fees of the Wolfson, Weiner firm that audited the parent company.

Smaller accounting firms may remain independent in such circumstances, but it would appear easier to do so if no client represents a significant portion of total fees. The complexities inherent in auditing large, modern businesses also suggest the need for larger, similarly complex public accounting firms. It does not appear that concentration of audit services has an adverse effect on independence; indeed, the favorable effects appear to dominate.

Throughout the world, certain characteristics of auditing remain constant. Effective independent audits of large entities are available to shareholders only in those countries where large public accounting firms practice. With the exception of Japan, broadly based equity capital markets failed to develop without the availability of independent audits conducted by large firms. A small number of large firms predominate in the United Kingdom, Canada, Australia, and West Germany. Two large Dutch firms audit many of the largest

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28. U.S. Senate, Subcommittee on Reports, Accounting and Management, *The Accounting Establishment,* p. 1729.

businesses in the Netherlands, while a single (Philippine-based) firm audits most of the larger corporations in Southeast Asia.

Recent actions of the governments of two countries are of interest. Both France and Japan have attempted to improve the ability of their own national accountants to audit larger entities by encouraging the growth of larger public accounting firms.[29] In France, the government removed the requirement that auditors must practice as individuals. In Japan, the government provided legislation allowing the formation of audit corporations and then actively supported the formation and growth of several of them.

The Overriding Effect of Time Pressures on the Quality of the Audit

The Commission's staff spent over 1,000 hours in a study to determine the underlying cause of substandard perfomance in a number of selected cases involving auditors.[30] In a related vein, the Commission conducted an extensive survey of present and former staff members and partners of auditing firms, principally to determine their attitudes and practices related to the quality of their work and independence. Members of the Commission and its staff held several meetings with the enforcement staff and other staff members of the SEC to discuss the causes of audit failures.[31] Staff and Commission members also met with a number of technical partners of public accounting firms to explore their views on the same subject.

The results of all this research may be summarized in a general way by stating that audit failures are due to mistakes in judgment because of excessive reliance on client representations.[32] This common formulation, although correct, provides little guidance in the search for the underlying cause of audit failures. An audit is a process of verifying selected client representations.

The auditor does accept many fundamental client representations without performing specific audit steps. He generally assumes, for example, that documents found in company files are not forged, that the company owns assets in its possession and used by it, and that the company's employees are who they represent themselves to be. On the other hand, items such as the client's representations as to amounts owed to it—accounts receivable—are the subject of exhaustive audit steps. The failure of an auditor to detect or disclose an error, omission, or misrepresentation means that, by definition, he has placed excessive reliance on client representations that he should have audited in a more effective manner.

Similarly, since the entire audit involves judgments as to which items should be audited, and the extent of testing to which they should be subjected, "poor judgment" is another apparent cause of all audit failures. Indeed, the fundamental cause of auditor failure is always "poor judgment in accepting client representations." Therefore, in their work, the Commission and the staff focused on attempts to determine what factors caused poor judgment and excessive reliance on client representations.

Although there are other factors, the Commission believes that excessive time pressures are the most pervasive cause of audit failures. These excessive time pressures stem from a number of sources—some in the business environment and others within public accounting firms. They appear in a number of forms, some of which may seem to reflect other causes but which are ultimately traceable to time pressure.

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29. Law of 31 October 1968 and Decrees of 19 February 1970 and 25 September 1970 cited in "The Profession Abroad," *The Accountants' Journal* 51 (October 1972): 91–93; *CPA Profession in Japan* (Tokyo: Japanese Institute of Certified Public Accountants, July 1976), pp. 4–5.

30. The staff analyses of cases involving alleged audit failures are described in appendix B.

31. The results of these discussions are contained in Wiesen, "Congressional and SEC Expectations" (described in appendix B).

32. Only the Equity Funding case might be excluded from this conclusion. There, the trial testimony and subsequent conviction of the auditors suggest an element of intent in addition to any "mistakes in judgment."

The term *time pressure* denotes both influences and attempts to reduce audit time. Time pressures may be the result of an effort to reduce the total hours devoted to an audit regardless of when the work is done. It may also be the indirect result of the imposition of a deadline date for completion. Of course, there are always some time pressures in an audit. An audit is conducted in a business environment; the service is performed and paid for by profit-making entities. Rational considerations of economy and efficiency will dictate attention to reasonable limits on the time expended in performing the audit without, however, impairing the quality of assurance desired and provided.

The concern here is with *excessive* time pressures, conditions under which the reasonable concern with efficiency is exaggerated to the point that the quality of the audit is adversely affected.

The research described earlier yielded a number of apparent causes of auditor failure: poor planning and inadequate supervision; lack of understanding of audit objectives and procedures; assignment of personnel with inadequate experience, training, or knowledge of an industry; and inadequate consideration of the selection or application of accounting principles. The analysis of cases which gave rise to these conclusions is included in the Commission's files. These elements of audit failure are reasonably well known to the profession. Indeed, many of the improved quality control procedures instituted in recent years have been aimed at these factors.

However, most of these factors appear to stem from a basic, underlying cause: time pressures. For example, the Commission's research found several examples in which audit failure related to inadequate supervision. However, while there was some evidence that the inadequate supervision related to individual deficiencies, far more pervasive was the picture of one partner supervising fifteen or twenty engagements, many with identical year ends, working considerable overtime, unable to find adequate time to review work papers, and faced with several crucial decisions, some of which were ultimately made incorrectly.

When senior personnel are spread too thin in this manner, supervision is jeopardized in three respects: First, the staff assigned to the engagement may not be adequately prepared for the audit; second, when questions arise on the engagement, supervisory personnel may not be available for consultation; and finally, the review of work performed may not be as thorough as required in the circumstances. A remarkable number of the audit failures fit this general picture.

Similarly, in cases of misapplication of accounting principles, the poor judgment involved was almost always made under the pressure of a time deadline to complete the audit at a fixed date. In some cases, auditors were persuaded to give an opinion before the completion of what eventually turned out to be false transactions. In other cases, items such as confirmation procedures were carried out in an incomplete manner because of deadlines.

The Commission's survey of staff and partners of audit firms also directly identified time-budget pressures as a primary cause of substandard audits.[33]

Closely related to budget pressures imposed by the public accounting firm are client time pressures that sometimes cause the auditor to subordinate judgment to unreasonable demands and, therefore, to compromise independence.

The ability to meet time budgets is believed by a majority of the respondents to the Commission's survey to be necessary for an individual to advance within a firm. The survey shows that the auditor's ability to use audit techniques efficiently to keep time charges low, his ability to meet time budgets, and the quantity of work produced, as measured in billable hours, are considered very important to personal success.

33. The survey is described in appendix B.

The survey also shows that 50 percent of the respondents believe that time budgets have a negative effect on the auditor's performance. Fewer managers and partners share this belief. Nevertheless, staff auditors responsible for important aspects of audits seem to place too much importance on the ability to meet time budgets.

Most disturbing, 58 percent of respondents still in public practice and 68 percent now out of the profession had signed for completing audit steps (not covered by another compensating step) when they had not performed the work. Of the several deficiencies revealed by the survey, the Commission believes that this is the most serious, for it reflects on the auditor's own control system for the audit. The final decisions on an audit are made by the partner; the work papers and, particularly, the signed work programs indicating the work done are the basic materials for his decisions. If the partner is not receiving reliable information about the extent of the work performed, he cannot make informed decisions. This response, and some of the others discussed later, appear to indicate significant problems. The survey identified budget pressure as the primary factor causing individuals to sign off required audit steps without completing the work.

Realistic budgets are, of course, necessary to control the audit. An audit is a service and the auditor must offer it at a competitive price. However, unacceptable consequences arise if competition creates such low fees that audit hours are reduced regardless of the effect on quality.

The Commission's survey indicates that 57 percent of those in the profession and 65 percent of those who have left the profession believe that audit programs and time budgets are unduly influenced by client-negotiated fees. Further, pressures to meet time budgets also cause approximately 48 percent of respondents to complete work on their own time without reporting the chargeable hours. Performing procedures without charging the time might be considered conscientious, but it also reveals the emphasis individuals place on meeting the budget. Time not charged is not billed, the partner again receives incorrect information, and the goals established for future audits are based on a false premise. To the extent supervisors believe that meeting the budget means a job well done, individuals are advanced and are, therefore, rewarded for the wrong kind of performance. The problem is intensified in the following year.

In summary, the profit motive, competition among firms, and the need to attract new clients and keep existing ones are, in the opinion of the respondents to the survey, emphasized too much. Therefore, it is reasonable to assure that excessive competition producing low fees can cause unrealistic budgets and that such budgets can increase substandard performance.

The Need for Improved Use of Budgeting Procedures in Accounting Firms

Time budgets, consisting of estimates of the total hours required for the completion of segments of the audit and for the entire audit, are the most common means of cost control used by public accounting firms. The time budget should provide the following:

- A basis for estimating the cost of the audit.
- A means of planning and allocating personnel within the public accounting firm and on the job.
- Some indication to staff members of the amount of work expected in specific segments of the audit.
- A means of monitoring the performance of staff auditors.
- A means for supervisors to review the efficiency and effectiveness of the time spent on each segment of the audit.
- A device, if correctly analyzed, for improving the efficiency of the audit and reducing its cost.

When the time budget is carefully constructed, particularly in the light of previous engagements for the same client, it may well achieve many of those goals. However, time budgets also appear to have less desirable consequences. A leading auditing textbook notes that

> the pressure to complete a job within the time estimate . . . is a significant aspect of public accounting, and the prospective employee or practitioner should either be prepared to expect and accept such pressure or he should plan on entering some line of work other than public accounting. The pressure is always present and is often severe, even to the extent that promotion or professional success will usually hinge on whether the accountant can work fast enough to keep within the time estimate.

However, it also notes that the time budget, once set, cannot determine how the job is done: "Adaptability to conditions as they actually exist is essential to the successful completion of an audit. The tail cannot be permitted to wag the dog."[34]

A disturbingly high proportion (more than 50 percent) of the respondents to the Commission's survey replied that pressures induced by time budgets had a negative effect on the quality of audits and that such pressures were increasing. While such comments came more frequently from senior and staff accountants, over one-third of managers and partners also responded that time-budget pressures were excessive. Members of the enforcement division of the SEC indicated to the Commission their belief that excessive time and budget pressure had been the cause of several poor audits. The Commission's own analysis of legal cases did not identify instances of time budgets causing audit failures. However, time pressure—not necessarily stemming from a budget—was clearly a significant problem. Also, problems of time budgets, as opposed to time pressure in general, would probably be revealed only by interviews of the staff involved, a step not undertaken by the Commission.

Even without a proven relationship to problem cases, the other evidence seems sufficient to conclude that present time-budget pressures reduce the quality of audits. Although some form of time budgeting is necessary, merely estimating hours for segments of the audit and analyzing performance only by comparisons with the original estimates is not effective. Public accounting firms should not abandon time budgets, but they must improve current methods, particularly for the evaluation of variances and their effect on the evaluation of personnel. When a budgeting system induces behavior such as signing off for work not performed or performing work but not recording the time for billing purposes, that budgeting system is producing conduct that is the opposite of the goals of a budgeting system and is inconsistent with professional auditing standards.

Any revisions of the budgeting process should include careful consideration of safeguards to avoid arbitrarily establishing excessively low budgets because fees have been set too low.

The Need for Further Study of Audit Staff Members

This report includes a number of recommendations for change that have grown from the Commission's survey of partners and staff members. It should be noted that some of the results are highly reassuring. For example, the accusation frequently heard, that staff members are pressured into conceding accounting points to clients, was denied by most respondents—respondents who otherwise were not loathe to reveal poor conduct on their part.

But, as noted frequently in this section, some of the results of that study are disturbing,

34. Howard F. Stettler, *Auditing Principles,* 3d ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1970), p. 430.

particularly those related to excessive time and budget pressures. The time pressure problem seems to be basic, the root cause of much substandard work and of apparent independence conflicts.

Time pressures which result in hidden incomplete work affect the audit firm's fundamental ability to control the quality of audits. The Commission's survey did not attempt to identify individual respondents by firm. The potential repercussions from time and budget constraints are so pervasive, however, that the individual firms need to learn the full extent of the problem and its underlying causes. The Commission believes that deficiencies in performance and attitude disclosed by the survey should be stopped as soon as possible.

The Commission recommends that individual public accounting firms immediately undertake to conduct studies to determine the extent of conditions revealed by the Commission's study, and the effects on their practices.

The Problems Caused by Early Earnings Releases

Auditors repeatedly complain of the problems created by early releases by the client of unaudited earnings information. A publicly held company often announces its earnings for the year in a press release issued shortly after the year end, well before the audit is completed. The client will usually ask the auditor, before the earnings release, if he has any audit adjustments that might affect the figures.

Nevertheless, there is considerable possibility that additional audit adjustments will be found. If they are, problems often arise in having them accepted by the client if they affect the originally released figures. There is a tendency to believe that the early release of annual results demonstrates management competence. Similarly, there is a belief that correction of the figures released earlier demonstrates a lack of management ability.

It is a simple matter to exhort the auditor to resist client pressures. Certainly, most auditors try to avoid compromising their independence in this manner. However, it would be preferable to devise a solution that would reduce the pressure on the auditor.

Conflicting needs in this area defy easy solution. Publicly traded corporations are generally obligated to release material information promptly. If corporate officers have no reason to believe that preliminary earnings information is misleading, they should make it available. Given the pressures of the market for earnings information, there could be penalties for not releasing the information, especially if it "leaks" before formal release. Therefore, it does not seem reasonable to prevent corporations from making early earnings releases. Indeed, prohibiting the release of unaudited information might only increase the pressure on the auditor to complete the audit.

While the Commission has been unable to determine any complete solution to this problem, we believe the situation would be improved if users were more clearly informed of the tentative nature of the early figures. A brief statement should be required on each page of the press release or other dissemination of early earnings release that might read as follows: "The accompanying results have been prepared by management; they may be subject to significant revision upon examination by the independent auditors."

Misunderstandings concerning releases of unaudited information would be reduced if greater and more consistent efforts were made by the financial press to indicate, when they are published, that such releases are unaudited.

Time-Deadline Pressures

Auditors frequently are under the pressure of time deadlines that threaten their ability to complete necessary audit work. Unrealistic time constraints are a factor in the often-cited errors in judgment made by auditors. Such errors often appear to have been made by auditors already working too many hours for too many clients.

This picture will be familiar, of course, to most accountants and auditors. The clustering of corporate year ends at December 31, along with pressures for the early issuance of annual reports, produces a flood of work at the same time of the year. Public accounting firms try to schedule as much work as possible at interim dates, but the year-end rush still exists.

These time pressures stem from various sources, but some of them are unnecessary. Timely financial reporting is desirable, but it is not clear that racing to issue the audited annual financial statements is useful. The efficient market hypothesis suggests that the market quickly reflects all publicly available information on corporations. Empirical investigations indicate that share prices are rarely affected by the issuance of annual reports; the market already has the information. However, as discussed in greater detail in sections 1 and 6, it does not follow that audited financial statements have no value. To the contrary, they assure that the initial information is correct and, if not, that it is corrected in the audited statements.

Audited statements should be timely, but timeliness is relative. The time period that is relevant is the period from the date an item of information becomes publicly known to the date the audited statements are released. The period from the financial year end of the company to the date of release of the audited financial statements is only a small portion of the total time period. Therefore, reducing the time between year end and the release of the audited financial statements is not particularly useful. A few days or weeks saved, possibly at the expense of a less thorough audit, are insignificant when the relevant period spans many months.[35]

The SEC requires that Form 10-K be filed 90 days after the year end. This deadline is the most commonly cited official time pressure. Discussion with auditors indicates that while the 10-K filing requirement provides some problems, it is not the most significant pressure. The most important common pressure is that of corporate management, attempting to meet arbitrary dates to release the annual report for the annual meeting of shareholders. The Commission believes that auditors should carefully assess the effect of such pressures on their work and refuse to accept such deadlines when they are imposed in opposition to their judgment.

Time Pressures in Registrations

The Commission's analysis of legal cases indicated that a high proportion of audit failures involve work in connection with registration statements. In those cases, a common element was time pressure exerted on auditors, especially at the supervisory level. In a celebrated case, one critical decision which, among others, ultimately resulted in criminal penalties, was made at the printer as the proofs were corrected.

Discussions with auditors and corporate financial executives and underwriters also indicate that substantial time pressures on auditors are caused by the deadlines imposed in registrations. There is, therefore, persuasive evidence of unusual time pressure on auditors during registration. Unlike the pressures discussed earlier, there appear to be some legitimate reasons for these time pressures.

The principal time pressures stem from the need to market securities. A substantial portion of the changes in securities prices and interest rates are attributable to general movements in the market. Companies obviously prefer to sell equities at the highest prices and to float debt issues at the lowest interest rates. Markets are, at times, believed to be either strong or weak. If a corporation is contemplating an issue of shares and the market seems strong, it will attempt to complete the registration as soon as possible.

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35. It might be assumed, for example, that the average "event" would have happened at the midpoint of the year—June 30. Thus, the time until the release of the audited statements would be over six months.

Since speed is important, the company and the underwriters will ask the auditor to complete his work as soon as possible. On some occasions, that request for haste may evolve into substantial time pressure, and, with some frequency, an audit failure.

One cannot simply admonish underwriters and corporations to ignore timing considerations in registrations. They are real and have an economic effect. The need for quality audit work is equally real. Thus, there must be some accommodation between the two.

The Commission's discussions indicate an almost excessive willingness of some auditors to be pressured in registrations. Underwriters have indicated that deadlines are often imposed for registrations without consultation with the auditor, and without protest by the auditor.

The principal response, therefore, must come from auditors. They must insist on being consulted, as early as possible, when registrations are contemplated. They must insist on being given the opportunity to consider deadlines and, most important, they must reject unrealistic deadlines when attempts are made to impose them.

The auditor has a unique problem compared with other parties involved in the registration. The company, the lawyers, and the underwriters must deliver tangible products if the financing is to proceed. If they are not finished, the necessary documents will not be available. The auditor, on the other hand, gives an approval (often involving issuance of a comfort letter to the underwriters) that looks the same whenever it is given. Thus, it is possible for him to be pressured to give that approval more quickly. Nevertheless, he must resist such pressures.

Of course, the entire burden cannot be placed on the auditor. Underwriters, lawyers, and corporate management must appreciate the auditor's concerns. The scheduling problems should not be deemed to permit unlimited pressure on the auditor.

Other changes may also help the auditor. In section 6, the Commission recommends that the audit function be substantially expanded to include greater and continuous involvement in the financial reporting process. The provision of interim assurances should be both eased and made more reliable if the Commission's recommendations in this area are implemented.

Corporations can also help. Companies that frequently come to the market often find it more economical to keep a registration continuously updated. With the increasing similarity between the Form 10-K and a registration statement, a continuously updated registration statement should be easier to maintain. Incorporation by reference of 10-K's and annual reports in registration statements would also help. Nevertheless, the final responsibility falls on the auditor not to concede to excessive pressure to complete his work.

Pricing Practices and Independence

As indicated earlier in this section, public accounting firms appear to be engaged in intensive price competition that often takes the form of pricing practices that could reduce the quality of audits, such as pricing below usual billing rates and giving fixed prices for more than one audit. The Commission believes that such competition should be discouraged only when it results in deterioration in the quality of the audit unknown to the user. In general, there should be no regulation of the way that public accounting firms set prices.

One exception should be made to this general rule. As noted earlier, the Commission has been unable to complete research projects on pricing and client solicitation practices. There are allegations, however, that firms sometimes offer relatively low fees for the first year or the first few years of an audit, with the expectation of recovering the initial loss in subsequent years.

An ethics ruling of the AICPA indicates that when the preceding year's audit fee remains unpaid, independence is impaired.[36] This prohibition is based on the belief that such a receivable from the client gives the auditor an interest in the financial success of the client and might influence his independence in carrying out the examination.

We believe that accepting an audit engagement with the expectation of offsetting early losses or lower revenues with fees to be charged in future audits creates the same condition and represents the same threat to independence. Consequently, the Ethics Division of the AICPA should consider this problem.

The Need to Adopt Policies on Gifts and Discount Purchases From Clients

An ethics ruling of the AICPA prohibits accepting more than token gifts from an audit client.[37] The Commission's survey of auditors indicated that a small number took gifts from clients, in amounts that the Commission cannot view as token. Many made purchases of client products at prices not offered to the general public. A third of the respondents indicated that their firms do not have policies on accepting gifts or buying at discounts.

While the Commission is not aware of any audit failures that have resulted from such actions—nor is it likely that any could be directly traced to such conduct—we believe that the receipt of special favors from clients is incompatible with the maintenance of an attitude of independence. All firms should develop for their staffs carefully drawn rules on these matters, and the AICPA should provide more definitive guidance on what amounts can be considered "token."

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36. Ethics Ruling No. 52 on independence, integrity, and objectivity states, "At the time a member issues a report on a client's financial statements, the client should not be indebted to the member for more than one year's fees" (AICPA, *Professional Standards,* vol. 2, ET section 191.104).

37. Ethics Ruling No. 1 on independence, integrity, and objectivity (AICPA, *Professional Standards,* vol. 1, ET section 191.002).

10 The Process of Establishing Auditing Standards

Auditing standards have two important uses: communicating the requirements of auditing and evaluating the performance of auditors.[1] First, auditing standards provide guidance to auditors in their practice, to users who want to understand the work of auditors, and to educators who prepare people to become auditors. Second, auditing standards may be used by the profession's bodies charged with disciplining auditors, the courts, and the regulatory agencies to evaluate the performance of auditors.

DEFINITION OF GENERALLY ACCEPTED AUDITING STANDARDS

By 1949, the American Institute of [Certified Public] Accountants had formally adopted ten broad requirements for audits of financial statements that are usually referred to as the generally accepted auditing standards. The ten formal standards cover three areas:

- General standards of professional competence, independence, and due professional care.
- Field work standards for planning and supervision, study and evaluation of internal control, and the sufficiency and competence of evidential matter.
- Reporting standards relating to compliance with generally accepted accounting principles, consistency of principles with those of the preceding year, the adequacy of financial statement disclosures, and the requirement to express an opinion or state that an opinion cannot be expressed.

The ten formal standards provide a framework for audits of financial statements, but not specific guidance. The AICPA has supplemented them by issuing various authoritative publications on auditing.

AICPA Pronouncements on Auditing

The most authoritative of the AICPA auditing publications is the series of Statements on Auditing Standards. The Statements amplify the ten formal standards—mostly with respect to audit procedures or the form and content of the auditor's report in various circumstances.

Statements on Auditing Standards are enforceable by the AICPA under Rule 202 of its Rules of Conduct:

> A member shall not permit his name to be associated with financial statements in such a manner as to imply that he is acting as an independent public accountant unless he has complied with the applicable generally accepted auditing standards promulgated by the Institute. Statements on Auditing Procedure [now Statements on Auditing Standards] issued by the Institute's Committee on Auditing Procedure [now the Auditing Standards Executive Committee] are, for purposes of this rule, considered to be interpretations of the generally accepted auditing standards and departures from such statements must be justified by those who do not follow them.

1. Ernest L. Hicks, "Standards for the Attest Function," *The Journal of Accountancy* (August 1974): 39–40.

The Auditing Standards Executive Committee, a part of the Auditing Standards Division of the AICPA, has been designated as the sole spokesman for the AICPA in the area of auditing. It is charged with continuing the development and interpretation of generally accepted auditing standards.

The division publishes two other types of guidance on auditing. Auditing interpretations are issued by the division's staff after being reviewed with members of the committee. They provide timely information on questions of current interest and explain the application of Statements on Auditing Standards to specific circumstances. The division also issues industry audit guides, prepared by task forces or subcommittees of the division, which cover auditing and reporting requirements for various industries and areas of practice. They carry substantial weight and are sometimes the only authoritative pronouncements.

SEPARATING STANDARD SETTING FROM OTHER ISSUES

This section of our report is concerned with the adequacy of the process and the means by which auditing standards are established.

The Commission reviewed the AICPA's efforts to establish auditing standards and considered the possibility of other approaches to standard setting. Records of the efforts of the Auditing Standards Executive Committee of the AICPA and the views of individuals knowledgeable about its operations were taken into consideration.[2] Some members of the Commission and its staff have had considerable experience with the committee, and their views were carefully considered.

This section is not intended to be an evaluation of the adequacy of individual pronouncements, how well they are observed in practice, or the disciplining of those who depart from them—matters that are considered elsewhere in this report.

EARLY SUCCESS IN ESTABLISHING AUDITING STANDARDS

The AICPA's efforts to develop generally accepted auditing standards officially began in January 1939.

The First Auditing Pronouncement

The Special Committee on Auditing Procedure was formed in response to the *McKesson & Robbins* case, a fraud that independent auditors had failed to detect. The fraud was carried out by collusion in the top management of the company. Of reported consolidated assets in excess of $87 million, approximately $19 million, primarily accounts receivable and inventories, were fictitious.

The committee's original charge was to "examine into auditing procedures and other related questions in the light of recent public discussion." In response to this charge the committee, in May 1939, submitted to Council *Extensions of Auditing Procedure,* and it was approved.[3] The Council also approved and incorporated into the statement a supplemental report of the committee at the Institute's annual meeting in September of that year. The extensions of auditing procedure required were primarily direct confirmation of accounts receivable with debtors and observation of the taking of physical inventories.

2. See AICPA Auditing Standards Division, "Auditing Standards Division: Responsibilities, Authority and Structure" and "Projects Presently in Process or Completed by the Auditing Standards Executive Committee (September 1965–January 1975)," 1975 (described in appendix B).

3. *Extensions* was later reissued as SAP No. 1, and the special committee became a standing committee. The AICPA had earlier published pamphlets on recommended auditing procedures and reports; however, they did not deal exclusively with auditing, and they were not a product of a continuing committee.

The SEC held hearings on McKesson & Robbins beginning in December 1938 for the purpose of evaluating the performance of the independent auditors involved and determining "the adequacy of the safeguards inhering in . . . generally accepted practices and principles of audit procedure to assure reliability and accuracy of financial statements." By the time the SEC issued its summary of findings and conclusions in Accounting Series Release (ASR) No. 19 (December 1940), the Institute had already issued *Extensions of Auditing Procedure.* The SEC concluded as follows:

> We have carefully considered the desirability of specific rules and regulations governing the auditing steps to be performed by accountants in certifying financial statements to be filed with us. Action has already been taken by the accounting profession adopting certain of the auditing procedures considered in this case. We have no reason to believe at this time that these extensions will not be maintained or that further extensions of auditing procedures along the lines suggested in this report will not be made.[4]

The SEC also stated a policy of relying on the public accounting profession to establish auditing standards. According to ASR No. 19,

> Until experience should prove the contrary, we feel that this program is preferable to its alternative—the detailed prescription of the scope of and procedures to be followed in the audit for the various types of issuers of securities who file statements with us—and will allow for further consideration of varying audit procedures and for the development of different treatment for specific types of issuers.

Development of the Generally Accepted Auditing Standards

In ASR No. 21 (February 1941) the SEC amended its rules to require, among other things, "that the accountant shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances." The Committee on Auditing Procedure began development of generally accepted auditing standards, but the effort was delayed by World War II. In October 1947, the committee issued its report—*Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope*— which contained nine standards subsequently adopted by the Institute's membership in 1948. The tenth standard is a paraphrase of a portion of Statement on Auditing Procedure No. 23, which was approved by the membership in 1949.

Past Evaluation of the Development of Auditing Standards

The efforts of the AICPA in developing generally accepted auditing standards have been regarded as relatively successful. John L. Carey contrasted its success in specifying audit responsibility with the difficulty in specifying accounting principles as follows:

> In contrast with the turmoil in which statements on accounting principles were developed, the enunciation of authoritative guidelines for independent audits has been a steady, orderly process. One reason for this, no doubt, is that the extent and adequacy of their examinations are the responsibility of the accountants alone, whereas management, auditors, and regulatory bodies have shared responsibility for the representations made in financial statements. In the development of accounting principles, therefore, management, the stock exchanges, and the SEC, as well as the accounting profession, have had an influential voice.[5]

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4. SEC Accounting Series Release No. 19, "In the Matter of McKesson & Robbins, Inc.," December 5, 1940.

5. John L. Carey, *The Rise of the Accounting Profession,* 2 vols. (New York: AICPA, 1969), 2:145.

In a research study on *Obtaining Agreement on Standards in the Accounting Profession,* Maurice Moonitz evaluated the AICPA's efforts in developing guidance on auditing as follows:

1. The AICPA can and has formulated a comprehensive set of auditing standards. They have been reduced to writing and in large part adopted by the membership. They are binding on all members in their practice as independent auditors. The organizational pattern fits the task to be done. The process works.
2. Why has the process worked in the case of auditing standards? The following factors are noteworthy:
   a. Within the organized profession, the pronouncements of the Committee on Auditing Procedure have the force of law.
   b. The organized profession has the means, through the Code of Professional Ethics, to enforce its rules for auditing standards.
   c. The subject matter of auditing standards and procedures is highly technical. As a result, laymen will ordinarily leave auditors alone to establish auditing standards, unless a scandal of the magnitude of *McKesson-Robbins* or of *Equity Funding* develops.
   d. The members of the Committee on Auditing Procedure have been drawn primarily from the practicing arm of the profession. They are mainly auditors, working with problems with which they are familiar, and in areas in which they have competence.[6]

At a time when the public accounting profession faces many new challenges, it is appropriate to reevaluate the adequacy of the standard-setting process.

THE CRITICAL QUESTION: WHO SHOULD SET AUDITING STANDARDS?

In any evaluation of a standard-setting process, the question of who should set the standards predominates. That question has been asked repeatedly with respect to accounting and auditing standards. Before adopting the securities acts, Congress considered federal chartering of auditors and having audits made by a corps of government auditors.[7]

Recently, the House Commerce Committee's Oversight and Investigations Subcommittee chaired by Representative John E. Moss recommended in its report that the SEC reexamine the advisability of setting accounting standards and standards for independent auditors who report on financial statements filed with the SEC.[8] A December 1976 study prepared by the staff of the Subcommittee on Reports, Accounting and Management of the Senate Committee on Government Operations, chaired by Senator Lee Metcalf, recommended that the government set accounting and auditing standards.[9]

From time to time, the SEC has considered the desirability of setting accounting or auditing standards. Its policy decision on auditing standards was discussed earlier. It

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6. Maurice Moonitz, *Obtaining Agreement on Standards in the Accounting Profession,* Studies in Accounting Research No. 8 (Sarasota, Fla.: American Accounting Association, 1974), p. 76.

7. See J. Wiesen, "Congressional and SEC Expectations Regarding Auditors' Duties," December 1976 (described in appendix B).

8. U.S. House of Representatives, Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce, *Federal Regulation and Regulatory Reform,* September 1976.

9. U.S. Senate, Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, *The Accounting Establishment: A Staff Study,* December 1976.

came to a similar conclusion on accounting standards.[10] However, the SEC's authority to set accounting standards is more explicitly related to the regulation of securities markets.[11]

The study group on the establishment of accounting principles chaired by Francis M. Wheat, a former commissioner of the SEC, gave extensive consideration to the question of who should set accounting standards and the relationship between the public accounting profession and the SEC in the establishment of standards.

Should a Government Agency Set Auditing Standards?

The Wheat study group concluded that the accounting standard-setting function should not be performed by a government agency. Its conclusions are even more persuasive when considered with respect to setting standards for auditors.[12] The Wheat study group expressed the belief that "transferring standard setting to a government agency . . . would inevitably sap the vitality of the accounting profession."

Removing from the profession the responsibility for setting auditing standards would have a distinctly negative effect on its vitality. Development of generally accepted auditing standards has increased the stature of the profession and contributed significantly to the maintenance of an attitude of professionalism. Auditors' professional identity has been enhanced by the responsibility to create and maintain the body of knowledge of independent auditing. This responsibility has long been considered an important characteristic of a profession. Established professions, such as law and medicine, traditionally have been expected to set their own standards.

Development of their own standards also increases auditors' authority with their clients:

> The auditors' ability to serve the public interest in examining and reporting upon financial statements is greatly enhanced by client's perception that the standards and expertise that the auditors bring to their work are largely the auditors' proprietary knowledge, rather than pronouncements of a public agency whose meaning and significance would be relatively more open to debate between auditor and client.[13]

That auditing standards are set by their own professional body undoubtedly motivates auditors to accept and support the AICPA's pronouncements on auditing. This motivation may not always be as strong as is desirable, but it would be vastly changed if auditing standards were rules established by a regulatory agency. Auditing standards require a professionalism in application that would be more difficult to maintain if they were established outside the profession.

That auditing standards are now set by a representative group of practicing auditors with wide experience provides assurance that other practicing auditors will generally be satisfied with the merits of the positions taken.

Finally, and most important, the Commission believes that no need has been established for taking the auditing standard-setting function from the domain of the accounting

10. The SEC's policy on the development of generally accepted accounting principles was originally stated in Accounting Series Release No. 4 in 1938 and was reaffirmed in Accounting Series Release No. 150 in 1973.

11. For a consideration of the SEC's authority in accounting as opposed to auditing matters, see James F. Strother, "The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards," *Vanderbilt Law Review* 28 (January 1975): 201–33.

12. The question of who should set the standards is discussed by the Wheat study group in Study on Establishment of Accounting Principles, *Establishing Financial Accounting Standards* (New York: AICPA, 1972), pp. 21–24.

13. Strother, "The Establishment of Generally Accepted Accounting Principles," p. 230.

profession. Such a drastic institutional change would involve substantial costs. It cannot be justified unless significant improvements are needed and can be expected to result from the change.

The Commission believes that the auditing standard-setting process has worked reasonably well. Neither the Commission's examination of significant cases against auditors nor any of its other research has uncovered significant evidence that audit failures are generally traceable to deficiencies in auditing standards. Failures were most frequently traceable to departures by auditors from the standards. Indeed, the outcomes of most court and regulatory actions have hinged on whether or not auditors have violated generally accepted auditing standards; with rare exceptions, conformity to auditing standards has established a meaningful defense for auditors.

Existing auditing standards could be improved, and many improvements are suggested in this report. However, the existing standard-setting structure appears quite capable of providing the necessary evolution.

The Commission's research and its discussions with interested parties have shown that there is often a tendency to confuse auditing standards with accounting principles and the setting of auditing standards with the problems of individual auditor performance. Some confusion over these distinctions by nonaccountants is inevitable, but the elements must be carefully separated for purposes of policy consideration. This section of the report deals only with the setting of *auditing* standards. Auditor performance is considered elsewhere; accounting principles are not within the scope of this Commission.

Standard Setting and the SEC

The relationship between the SEC and the AICPA in setting auditing standards has worked well. The early, successful cooperation evidenced by the responsiveness of the AICPA to ASR Nos. 19 and 21 has continued. For example, in ASR No. 153 (February 1974), the SEC noted that communication between an independent auditor who had resigned an engagement and his successor was inadequate. The Auditing Standards Executive Committee promptly added the subject to its agenda and in October 1975 issued SAS No. 7, *Communications Between Predecessor and Successor Auditors,* which made inquiry of a predecessor auditor a required auditing procedure and provided additional guidance on the form and significance of the communication.

Members of the committee meet periodically with the SEC's chief accountant and his staff to discuss problems of mutual interest and priorities for pronouncements. For example, in January 1974, the chief accountant of the SEC requested consideration of the auditor's responsibility for other information in documents containing audited financial statements. The committee issued SAS No. 8, *Other Information in Documents Containing Audited Financial Statements,* in December 1975. It provides guidance on matters such as the auditor's responsibility when data appearing in both the audited financial statements and other portions of an annual report are not consistent.

From 1973 to 1975, the committee and the chief accountant and his staff discussed possible forms of auditor association with interim financial information. Since a substantial extension of the auditor's service was involved, the issues were complex. They required subjective evaluation of the benefits and costs associated with the auditor's involvement and a definition of the precise nature of that involvement. The relationship was strained by disagreement about whether the new form of auditor involvement should be a mandatory part of an annual audit or a separate service available to a client at its discretion. There were also less divisive disagreements on the examination procedures and form of reporting.

The SEC appears to have the authority to mandate auditor involvement by requiring disclosure of interim information in audited annual financial statements: "The inclusion of

interim data in the footnotes to annual financial statements necessarily will associate the independent public accountant with these data in some fashion."[14]

In its initial proposal, the SEC indicated that the interim data should not be labeled "unaudited." It received many comments suggesting that an audit of interim data would be unnecessarily costly and decided to permit the note containing interim data to be labeled "unaudited." However, the auditor would still be associated with the data and the precise nature of his responsibility had to be specified.

ASR No. 177 noted that "the Commission does not believe it is appropriate for independent accountants to be subjected to unknown responsibilities in connection with their association with this note." Consequently, when ASR No. 177 was issued, the SEC proposed a set of limited review procedures that auditors would be expected to follow when they were associated with financial statements containing an unaudited note on interim data.

ASR No. 177 also noted the long history of cooperation with the committee and expressed the SEC's desire to continue that policy:

> Historically the Commission has not been required to set forth the standards and procedures which underlie an independent public accountant's report because the public accounting profession has developed appropriate standards and procedures to provide protection to the investing public who rely upon such reports.
>
> The Commission believes that it is preferable to continue its past policy of permitting the accounting profession to determine the auditing standards and procedures underlying accountant's reports as long as this policy is consistent with the interests of investors.

The SEC noted that the subject of auditor involvement with interim data had been under active consideration by the Auditing Standards Executive Committee and urged the committee to

> continue its study of auditor involvement with interim financial data in the light of the Commission's determination that certain interim data shall be included in annual financial statements of certain registrants in a note labeled "unaudited" and the Commission's further determination that auditor association with these data will necessarily occur and the responsibilities for such association must be satisfactorily defined.

The SEC indicated that if the committee adopted an SAS before December 10, 1975, that satisfactorily defined the standards and procedures for auditor involvement, it would withdraw its proposed procedures. In December 1975, the committee issued SAS No. 10, *Limited Review of Interim Financial Information,* and the SEC withdrew its proposal. In SAS No. 13, issued in May 1976, the committee prescribed the form of reporting on a limited review.

Thus, the SEC concluded that auditor involvement should be mandatory in certain circumstances and required that involvement. The determination of the work and reporting necessary to satisfy the responsibilities arising from that involvement was made by the committee.

The next similar issue was handled more smoothly. In ASR No. 190 (March 1976), the SEC required the disclosure of certain replacement cost data for certain companies. Again, the SEC concluded that the required data could be labeled "unaudited" but had to be

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14. SEC Accounting Series Release No. 177, "Notice of Adoption of Amendments to Form 10-Q and Regulation S-X Regarding Interim Financial Reporting," September 10, 1975.

included in the financial statements, which meant the auditor would be associated with the data.

The SEC urged the committee "to develop appropriate standards applicable to the auditor in the case of such association." In December 1976 the Committee exposed an SAS on the procedures to be applied to replacement cost information in a note to audited financial statements.

Having both the SEC and the AICPA separately set auditing standards could result in conflicting regulations and the lack of a coherent framework. Many corporations, partnerships, and nonprofit organizations, and some regulated business entities do not report to the SEC. All these organizations may need independent audits. Their audits should be conducted within the same broad framework as those of companies that file with the SEC.

When the SEC has believed there was a need to do so, it has been able to achieve adequate influence over the auditing standard-setting effort. There is no reason to believe the SEC will be unable to exert the necessary influence to protect investors in the future.

This interaction between the SEC and the Auditing Standards Executive Committee is not comparable to the more common situation of discussions and negotiations between government regulatory agencies and the representatives of regulated industries. The accounting profession is not "regulated" by the SEC. The examples noted above represent a process of attempting to work together to develop better performance standards. Unlike the typical case in industry, the revenues of the accounting profession are not significantly reduced by the outcome. Indeed, the revenues of the accounting profession would have been substantially increased by the initial SEC proposals for interim reporting discussed above.

The profession's positions, of course, are motivated by a form of self-interest. It is a self-interest, however, that appears principally in attempts to preserve a standard of quality and in reactions—possibly excessive—to fear of litigation.

Should the Standard-Setting Body Be Independent of the AICPA?

Concluding that the standard-setting process should not be transferred to a government agency does not necessarily mean that the process should continue within the AICPA. For example, the Wheat study group opposed transfer to a government agency, but recommended that a body independent of the AICPA be established to set accounting standards. However, the considerations that led to that conclusion on accounting do not necessarily apply to auditing. The Wheat study group considered the desirability of having the independent body they recommended establish both accounting and auditing standards. On that matter, their report states,

> We think it proper that the Institute's Committee on Auditing Procedure should continue to be responsible both for audit procedures and the auditor's report. The reconstituted Standards Board that we are proposing will not, or at least may not, be composed wholly of CPAs. Some of its members in the future may not have had direct experience in auditing and *they should not be asked to pass judgment on matters concerning the auditor's responsibilities.*[15] (Emphasis added.)

In addition, there are other, more important, reasons for keeping the responsibility to set auditing standards within the AICPA.

The Limited Interests of Outsiders. Auditing standards, audit procedures, and the

15. Study on Establishment of Accounting Principles, *Establishing Financial Accounting Standards*, p. 71.

auditor's report are technical matters that have traditionally been established by auditors with a minimum amount of participation or concern by outsiders. In contrast, outsiders have been particularly interested in accounting principles because of their effect on reported results and financial position. A variety of outside groups have demonstrated a strong interest in accounting principles, including management, investors and creditors, financial analysts, and government agencies. Until recently, auditing has not attracted anything approaching that degree of interest.

Clients have always been interested in the size of the audit fee and to that extent take an interest in auditing standards and procedures. However, the nature and extent of that interest are small when compared with the interest in accounting principles.

The lack of participation or concern by outsiders is understandable. Independent auditors are expected to perform the audit function and satisfactorily fulfill their responsibilities to users of their work. In the absence of widespread failure, there is little reason for outsiders to become involved in the means that auditors collectively agree should be used to achieve those goals. However, on questions that involve new or extended services, increased interest and participation by outsiders are more likely.

It does appear, however, that the present mechanism, which limits the committee to practicing CPAs, does not encourage, and may well discourage, outside participation. The Commission believes that greater outside participation is desirable, particularly for Industry Audit Guides and similar areas. Suggestions for encouraging greater outside involvement are made later in this section.

The Public Interest. The AICPA's auditing standard-setting process is effectively subject to the supervision of regulatory bodies and the courts. Both have found it possible to indicate when they believe standards fall short of what is required in the public interest, and the AICPA has been responsive.

A number of AICPA pronouncements on auditing followed court decisions. For example, SAP No. 37, *Special Report: Public Warehouses—Controls and Auditing Procedures for Goods Held,* was issued in 1966 because of the "salad oil swindle." SAP No. 41, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,* was issued in 1969 in response to the decision in the Yale Express case.[16]

Thus, the public is readily and fully represented by two major institutions in society: regulatory agencies and the courts. It is doubtful that an independent body is needed to provide a better vehicle for the expression of that public interest.

Organizational and Economic Considerations. The establishment of a separate organization for the determination of auditing standards would involve significant economic and organizational problems. The Financial Accounting Standards Board has required a long and expensive start-up period. The FASB must maintain separate and costly complete facilities for the performance of a single function: the development of accounting standards. While the burdens imposed by those costs have not been insurmountable, they have consumed considerable time and effort of the board's leadership and remain a continuing problem.

A separate auditing organization would encounter similar problems. The obvious question is whether the assumption of such costs would be warranted by the magnitude of present problems. The probability of improved solutions must be weighed against the benefits of undisturbed continuation of an easily financed process operating within the

16. The relationship between court decisions and auditing pronouncements is considered in Henry R. Jaenicke, "The Impact of the Current Legal Climate on the Accounting Profession," July 1976 (described in appendix B).

AICPA. The Commission concludes that the potential disadvantages, including the unknown probability of success of a new body, far outweigh any possible benefits.

THE PRESENT PROCESS AND ITS WEAKNESSES

As the preceding discussion indicates, the present process is satisfactory overall, and we do not believe that drastic changes promise significant improvement. However, several improvements are needed.

Operations of the AICPA's Auditing Standards Division

The Auditing Standards Division consists of the Auditing Standards Executive Committee, subcommittees, task forces, and staff.[17]

The Auditing Standards Executive Committee has twenty-one members, all of whom must be members of the AICPA. At present, twenty are in public practice and one is an academic accountant. At times, one of the public practice seats has been held by a member employed by a government agency. Traditionally, about half the public practice seats have been continuously occupied by partners from among the fifteen largest accounting firms.

The committee is authorized to publish Statements on Auditing Standards on its own authority without approval from the AICPA's Council or its Board of Directors. Pronouncements of other Institute committees that refer to auditing matters must be cleared with the committee chairman. He also clears audit guides prepared by separate task forces or subcommittees of the division and auditing interpretations prepared by the staff. Members are appointed annually by the chairman of the Board of the Institute with the approval of the Board of Directors. Normally, a member's service is limited to three years. All members serve part-time without compensation from the AICPA.

Staff support is provided by the AICPA and presently includes the full time of six people. Staff for the committee consisted of one or two people until 1970 and has since grown steadily to the present six. Some limited research support is also provided by the firms of members.

Statements on Auditing Standards are enforceable under the AICPA's Rules of Conduct and require approval by a two-thirds majority of the committee. Before issuance, Statement drafts are exposed for public comment, normally for two months. Approximately 25,000 copies of each exposure draft are mailed to various individuals and groups including all practice offices of firms that have Institute members and other interested parties, such as state societies, the SEC, the stock exchanges, and any individual who requests a draft.

Industry Audit Guides are prepared by separate subcommittees or task forces of the division. At times, executive committee members serve on these groups, but they are usually made up of other AICPA members in public practice who are familiar with the industry under consideration.

Criticisms of the Present Process

In contrast to the amount of criticism generated by the accounting standard-setting process, suggestions for change in setting auditing standards have been infrequent.[18]

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17. This discussion gives the highlights of the present operation. A more detailed description can be found in Hyman Muller, "The Auditing Standards Division: Responsibilities, Authority, and Structure," *The Journal of Accountancy* (September 1975): 50–54.

18. The comments of the recent reports of the House Subcommittee on Oversight and Investigations and the staff of the Senate Subcommittee on Reports, Accounting and Management are obvious exceptions to the general trend.

In part, this results from the relative lack of public interest in auditing standards as compared with accounting standards. However, our study suggests that the process does have weaknesses and can be improved.

Public Company Orientation. There are two distinct types of audit practice within the profession. One is auditing the financial statements of companies whose securities are publicly traded. Most pronouncements on auditing are oriented to this type of practice. Indeed, the Commission's consideration of the role of the auditor in society focuses primarily on responsibilities in this area.

However, another important area, practice related to nonpublic entities, differs in several significant respects. Here, the client is often the primary beneficiary of the CPA's services. The CPA's work and his report may be used by outsiders, but they are usually parties with a direct and close relationship with the client, such as bankers. The services provided frequently include accounting services—such as recordkeeping and tax return preparation—and business advice. When an audit is performed, it is often to give the manager-owner of the business an added measure of assurance.

This second area of practice has not been given significant attention by the Committee.[19] These accounting, auditing, and related services are important because they are provided to millions of small businesses that constitute a substantial part of economic activity in the United States. They require a high degree of competence and well-developed standards.[20]

More recognition should be accorded to this area of practice and more guidance specifically applicable to this type of work should be provided. Complaints have frequently been made that the present auditing standards, with their orientation toward publicly held companies whose securities are publicly traded, impose unwarranted requirements on the audits of other entities. It is suggested that those unnecessary requirements make independent audits impractical for small companies, thus resulting in "unaudited" statements when audit assurance is desirable.

The Commission has not studied those complaints, but it believes that they should be examined carefully. The users of the audited statements of nonpublic companies differ significantly enough from investors in public companies to suggest that not all the requirements of every Statement on Auditing Standards should apply. For example, the Commission's recommendation on extension of the auditor's role in section 6 would not be applicable to this area of practice.

Quality of Guidance. Many pronouncements could usefully provide more specific guidance. In particular, when a pronouncement deals with the nature and extent of audit procedures to be applied, there appears to be a tendency to make the guidance as general as possible.

Section 543 of SAS No. 1, "Part of Examination Made by Other Independent Auditors," for example, provides guidance on whether an auditor of consolidated financial statements can report on those statements when other auditors have audited subsidiaries or divisions included in the consolidated totals:

> In deciding this question, the auditor should consider, among other things, the materiality of the portion of the financial statements he has examined in comparison with

19. Recently, a separate subcommittee was appointed on accounting and review services to consider this area of practice, but this area of practice and the different requirements that may be applicable because of the nature of the practice require more attention.

20. See also the discussion of inconsistent and uninformative reporting on unaudited information in section 7.

> the portion examined by other auditors, the extent of his knowledge of the overall financial statements, and the importance of the components he examined in relation to the enterprise as a whole.[21]

The auditor is given no specific direction on how large a portion of the financial statements can be examined by other auditors. In practice, great variation is encountered to the apparent confusion of users. The committee could reasonably have specified some percentages that should ordinarily be considered material and the factors involved in evaluating the importance of a component or the extent of knowledge of the overall financial statements that the auditor should possess.

Similar examples could be given from several other pronouncements dealing with the amount of audit work to be performed. Sometimes the guidance is so general that almost any existing practice is permissible; for example, the following appears in SAS No. 9:

> The independent auditor may make use of internal auditors to provide direct assistance in performing an examination in accordance with generally accepted auditing standards. Internal auditors may assist in performing substantive tests or tests of compliance. When the independent auditor makes such use of internal auditors, he should consider their competence and objectivity and supervise and test their work to the extent appropriate in the circumstances.[22]

The SAS gives no guidance on when such use of internal auditors is permissible or how to determine the extent of supervision and testing required. Other sections of this report specify other areas in which the guidance provided should be more specific.

The committee has also been criticized for devoting a disproportionate amount of its effort to the form of audit reports at the expense of the development of guidance on audit procedures and new auditing methods. That may be caused by the general reluctance to be specific about the amount of audit work required. However, a more probable cause is the view that innovations in auditing are proprietary matters—an attitude that is most prevalent among large public accounting firms. Any competitive advantage that might be gained by developing methods and approaches to auditing might be lost if the new knowledge was shared. That view is not in the long-range interest of the public or the profession.

Timeliness of Guidance. The effectiveness of a standard-setting group cannot be measured simply by counting the number of pronouncements issued in a given period of time or by determining the length of time required to develop a particular pronouncement. Nevertheless, productivity in a period of great change is important, and the committee's productivity could be improved.

In its early life, the committee often issued pronouncements within one year of the inception of a project. The committee was much smaller, and its members were not as geographically dispersed. Recently, the time it takes to issue a pronouncement has typically lengthened to two years. This increased period can be attributed to a larger number of issues requiring resolution, the greater complexity of those issues, and the difficulty of reaching a consensus in a larger group. While a two-year development period might be understandable, the time occasionally has been considerably longer.

Some pronouncements clearly took too long to develop. For example, the Continental Vending case, which was decided in November 1969, involved several significant issues,

21. Statement on Auditing Standards No. 1, section 543.02 (AICPA, *Professional Standards,* Vol. 1, AU section 543.02). See section 7 for our recommendations on reporting in those circumstances.

22. Statement on Auditing Standards No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination* (December 1975), paragraph 10 (AICPA, *Professional Standards,* vol. 1, AU section 322.10).

including the auditor's responsibility for searching for and disclosing transactions at less than arm's length with the audited entity. Continental made loans to an affiliate that proved to be uncollectible because the affiliate had in turn loaned the money to Continental's president who used it in personal stock market dealings. The details of that transaction were not disclosed to investors. In February 1969, before the decision in the case, the committee placed the subject of related party transactions on its agenda. A pronouncement on the subject was not issued until July 1975—SAS No. 6, *Related Party Transactions.* In the intervening period, other cases occurred involving failure to detect or disclose related party transactions. However, the difficulty of reaching a consensus on a few critical issues delayed its release.

There has also been criticism of the failure to anticipate problems sooner and establish some kind of "early warning system" to handle emerging auditing problems. Although the committee has been responsive to problems raised by the SEC and in the courts, some of those problems might have been less severe if it had been able to identitfy and resolve them sooner.

Quality of Members and Staff. Another frequent criticism concerns the quality of staff support and the effectiveness of the participation of some members.

In recent years, the number of staff supporting the auditing standard-setting effort has greatly increased; quality has also improved, and the effort requires continuing improvement.

Two factors combine to reduce the effectiveness of the participation of members. First, the AICPA policy, applicable to all committees, of allowing a member to serve on a committee for only three years slows the momentum of some projects and often results in less capable people replacing members who have served three years. Second, all members serve on a voluntary part-time basis and often have significant client responsibilities, so that the amount of time they can devote is less than is desirable.

RECOMMENDED CHANGES IN THE AUDITING STANDARD-SETTING PROCESS

Steps should be taken to improve the committee's ability to identify problems and provide guidance on a more timely basis.

A Full-Time Board

The present committee should be replaced by a smaller full-time Auditing Standards Board, appropriately compensated. The importance of setting auditing standards and the demanding nature of the task require that the members serve full time and that the quality of staff support be improved. Public accounting firms should be willing to make the sacrifices required to release competent people for this purpose for a period such as three years. Setting auditing standards is now the most important professional activity reserved to the AICPA. It deserves the undivided attention of those who lead the activity.

The Auditing Standards Board should be a small group of, for example, five to nine members. Most of the members should have substantial and diverse audit experience, including experience in audits of companies whose securities are publicly traded. The appointment process used for the present committee need not be changed substantially, that is, appointment by the chairman of the Board of the AICPA with the approval of the Board of Directors. Staggered three-year terms seem appropriate, with reappointment for another three-year term possible. A board member need not be prohibited from returning to public accounting practice. No significant potential conflict of interest would exist between service on the board and audit practice. Indeed, service on such a board should improve a member's capacity for leadership in a firm or the profession.

To assist it, the Auditing Standards Board should appoint task forces and subcom-

mittees from among AICPA members, as is the current practice of the Auditing Standards Executive Committee. The board should consider appointing standing subcommittees for major areas of practice. For example, one subcommittee could be charged with the development and interpretation of auditing standards for audits of companies whose securities are publicly traded. Another subcommittee could be charged with the development of standards for accounting and related services and audits of small or closely held businesses.

A full-time board will require a larger, highly qualified staff. Maintaining a highly qualified staff is difficult for a professional organization. There is no simple solution, although higher visibility of the staff members will help competent people in the profession recognize the opportunities a staff position holds. Compensation should be commensurate with the responsibilities of such positions. Within a budget allocated by the AICPA, the board should select its own staff and make all personnel decisions.

Other possibilities should be explored, such as the type of fellowship program in which a firm commits a person to work full time on the staff for a period of two years. Similar programs are now operated by the SEC and the FASB.

The structure and operations of the proposed Auditing Standards Board have deliberately not been specified in great detail. The Commission believes that an appropriately competent initial membership of the board is best suited to develop these procedures.

Form of Guidance

Many of the recommendations made in other sections of this report would require changes in the ten generally accepted auditing standards. These changes should be made as part of a coordinated program.

The present generally accepted auditing standards are geared to the audit of historical financial statements. They should be changed to recognize that independent auditors are associated with information other than financial statements and to recognize that not all of this information is audited.[23] Among the primary changes required is a separate set of standards for the preparation of unaudited financial statements and related services. However, we have not considered, and make no recommendations on, the form of these standards.

The standards for the audit function should have broader scope than the present standards.[24] They should be applicable whenever a CPA undertakes an audit engagement. The basic standards for the audit function should include some standards similar to the present standards. For example, the general standards of proficiency, independence, and due care could be adapted with minimal change, as could the first standard of field work on planning and supervision. However, the third standard of field work on the sufficiency and competence of evidential matter should be made broader, without the specific reference to financial statements and an opinion on them. Recommendations made in sections 6 and 7 would require significant changes in the standards of reporting.

The restructuring should incorporate a statement of the independent auditor's role. This statement should be the result of consideration by the Auditing Standards Board of the auditor's role as suggested in this report. It should be periodically revised to keep it current with the changing needs of society. An authoritative statement of the auditor's

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23. A similar proposal to restructure the generally accepted auditing standards is made in Hicks, "Standards for the Attest Function." Our proposal, however, differs in several respects.

24. An AICPA committee is studying the subject of general standards applicable to all areas of a CPA's practice, including management advisory services and tax services as well as accounting and auditing services. Naturally, the restructuring of standards proposed here should be coordinated with that effort.

role would provide a broad framework and recognize that effective performance of the audit function depends heavily on the judgments and actions of the individual independent auditor in the field.

Participation in the Process of Setting Standards

No matter how experienced or knowledgeable are the members of any group, its pronouncements will benefit from the participation of knowledgeable people outside the group.

Participation Outside the Profession. When the FASB was established, it had a mandate to carry out its activities to the fullest extent possible in the public arena. As previously explained, the setting of auditing standards does not involve the same considerations as the setting of accounting standards. Auditing standards do not command the same wide public interest as accounting standards and this lesser public interest is understandable. With one exception explained below, the setting of auditing standards does not need to operate to the fullest extent practical in public.[25]

However, other groups who do have a strong interest in auditing standards should be encouraged to become more involved in the standard-setting process. For example, the Financial Executives Institute has a Committee on Financial Reporting with a subcommittee that reviews and comments on all exposure drafts of the Auditing Standards Executive Committee. This type of participation should be encouraged. Other groups that do not now comment on exposure drafts should be requested to establish standing committees to do so. For example, the American Accounting Association might be requested to participate more actively.

Some auditing projects have a greater public interest than others. Pronouncements that deal with the extent of audit work are not generally of interest to outsiders unless they are inadequate. However, projects such as revision of the auditor's standard report and other aspects of communication are of interest to outsiders. Of particular interest to outsiders are projects involving the extension of audit services, such as involvement with interim data and earnings forecasts. Since the need for extension of the auditor's services is likely to increase, there will be a corresponding increased need for the participation of knowledgeable outsiders.

Industry Audit Guides appear to constitute a special case in which particular attention should be paid to obtaining the participation by management in the affected industry. Some special groups of financial statement users may be involved, such as the trustees of hospitals and universities or representatives of government funding agencies. Particular efforts should also be made to encourage their participation.

The people who should participate are those knowledgeable about the financial reporting environment and the role that auditors play in it. For example, securities analysts, bankers, attorneys, academic accountants, and government auditors could usefully participate.

While the Commission has concluded that there is a need for formal outside participation in the process of setting auditing standards, it has no specific recommendation on the precise form this participation should take. There are two distinct possibilities: An advisory committee of about a dozen knowledgeable outsiders could be appointed to consult with the board; or, more direct participation would be possible if a few knowledgeable outsiders served directly on the board or on its subcommittees.

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25. As explained in section 11, it is far more important that the enforcement of auditing standards and the disciplining of those who depart from the standards be conducted in the public arena. Outsiders have a strong and legitimate interest in the disciplining of those who depart from professional standards.

The fact that the board members will serve full time and deal with many questions involving the extent of work and specific audit procedures as well as reporting and extensions of service would favor an advisory role for outsiders. However, participation without the ability to influence directly the outcome of issues under consideration would not encourage a high degree of involvement.

Participation Within the Profession. As stated above, in contrast to setting accounting standards, the setting of auditing standards has never commanded a wide degree of interest, even within the profession. For example, the FASB receives comments on exposure drafts and discussion memorandums that normally number in the hundreds. Few, if any, recent exposure drafts on auditing matters have received a hundred comments. Considering the number of members of the AICPA who are in practice in public accounting, the degree of participation within the profession is unacceptable.

The auditing standard-setting effort should be supported by the entire profession, and assurance of that support requires a sufficient sense of continuing participation in the effort. However, the auditing standard-setting effort is an unknown to too many AICPA members. The Auditing Standards Board should increase communication about its work within the profession.

More needs to be done to encourage the participation and interest of the academic arm of the profession in setting auditing standards. A standing committee of the American Accounting Association to comment on exposure drafts would help. In addition, the Auditing Standards Board should take an active interest in research to support the auditing standard-setting effort. The board should, of course, assign projects to its staff, but it should also identify projects that could more efficiently or effectively be performed by academic researchers. The board should identify researchers competent in auditing and arrange to provide them with the assistance of public accounting firms both in funding the research and gaining access to needed data.

Operating Procedure

Since 1939, when the effort at setting auditing standards began, there is no record that the AICPA ever undertook a formal review of the operations of the committee. Yet, changes can normally be made to improve the operations of any group. For example, the practice of allowing members who vote against a pronouncement to publish their dissents has frequently caused unnecessary delay and might well have been eliminated.[26] The board should have a periodic review of its operations to identify needed changes and improvements.

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26. See the Study on Establishment of Accounting Principles, *Establishing Financial Accounting Standards,* pp. 38–39, for additional discussion of this issue with respect to accounting standards. The Wheat study group recommended that dissents not be published.

11 Regulating the Profession to Maintain the Quality of Audit Practice

Regulation of the public accounting profession is necessary to control the quality of audit performance and prevent audit failures. Those objectives can be achieved through four complementary means: standards of competence, technical and ethical standards, practice controls, and mechanisms for imposing penalties. The Commission has evaluated the adequacy of the first two elements of the system of regulation in other sections of this report. This section considers the adequacy of practice controls and mechanisms for imposing penalties. Our overall conclusions are that the existing elements of regulation should be considered not in isolation but as a total system established and maintained by firms, the profession, state bodies, the SEC, and the courts, and that the system is performing reasonably well. However, this section includes recommendations for further improving the effectiveness of that system.

PROTECTING USERS FROM SUBSTANDARD PERFORMANCE

Substandard performance by auditors may affect large segments of the public as well as the client who engages and pays the auditor. The extent of substandard performance is not known precisely. Poor audits receive attention most often when the client encounters financial difficulties sufficient to lead injured parties or the SEC to investigate the possibility of substandard work. Substandard audits of entities that are not having financial difficulties are likely to go undetected.

Performance failures in professions are ultimately traceable to human failure; therefore, they cannot all be eliminated.[1] Although regulation of professional service cannot assure that the desired level of quality will always be reached, all professions develop systems of regulation to reduce failures. Indeed, one characteristic of a profession is that it seeks to regulate and improve the quality of practice.

The system of regulation of the public accounting profession includes four elements:

- Establishing high standards of skill and competence both for entering the profession and for continuing the right to practice.[2]
- Developing and promulgating technical and ethical standards that serve both as performance goals and as means of measuring departures.[3]
- Designing and implementing quality control policies and procedures to monitor and encourage compliance with the technical and ethical standards.[4]
- An effective disciplinary system to impose penalties for performance or conduct that departs from standards established by law, SEC regulation, or the profession.

The overall effectiveness of regulation depends on the satisfactory performance of all four elements operating and interacting as a system.

1. The staff analyses of cases involving alleged audit failures are described in appendix B.
2. Standards of skill and competence are considered in section 8.
3. The process of establishing auditing standards is considered in section 10.
4. The phrase "quality control policies and procedures" is commonly used in professional literature. See, for example, Statement on Auditing Standards No. 4, *Quality Control Considerations for a Firm of Independent Auditors* (December 1974) (AICPA, *Professional Standards,* vol. 1, AU section 160). A phrase that better indicates the purpose of the activity would be "policies and procedures for practice surveillance."

The system of regulation includes both private and governmental activity. In varying degrees, public accounting firms and professional organizations are active in all four elements of regulation. To that extent, the profession is self-regulated. However, state and federal agencies and the courts are also involved in all four elements. Given this mixed system, it is not useful to consider the private and public aspects separately.

In recent years the public accounting profession has devoted considerable self-regulatory effort to creating high requirements of competence, setting more rigorous technical and ethical standards, and designing and implementing better measures to control quality. In contrast, the profession has not been as successful in improving its own disciplinary mechanism. Dissatisfaction is frequently expressed with the profession's procedures for imposing penalties, particularly with the secrecy that surrounds the disciplinary mechanism and the inability to penalize firms. However, professional self-discipline is only one aspect of the system of regulation.

However, we believe that the total system as it now exists, including litigation and actions by regulatory bodies, provides a reasonable level of protection to the public. Nevertheless, improvements in the system are warranted and should be implemented.

INFLUENCES ON THE REGULATORY MECHANISM

The nature of professional practice and the types of practice units found in public accounting influence the regulatory mechanism.

The Nature of Professional Practice

Since a profession offers a service and not a physical product, control of quality is more difficult. Greater control over the quality of a physical product can be achieved by specifying tolerance limits and routinely, sometimes mechanically, testing conformity with them. Similar controls cannot be applied to professional services.

Quality controls in a profession cannot be adjusted as quickly as production controls. A profession's regulatory mechanism is designed to influence human abilities and behavior. Consequently, it will function gradually and with varying degrees of effectiveness. There will be unavoidable lags between changes in standards and changes in performance. This suggests the profession must continuously monitor performance, deal quickly with substandard performance, and attempt to anticipate future problems.

The Significance of Large Firms

Public accounting is unique among the professions in the range of the size of its practice units and firms. Practice units range from sole practitioners to offices with dozens of partners and hundreds of professional staff. Firms range in size from one individual to hundreds of partners and thousands of professional staff operating throughout the world. This diversity has affected the profession's ability to regulate itself.

Large practice units require controls to assure consistency of performance in some areas that small units do not need. Most large firms have installed controls such as professional development programs, in-house quality reviews, and policies for assignment of personnel, for supervision of field work, for maintaining independence, and for making use of experts within the organization. We have been unable to determine their effectiveness, but the improved quality control systems designed by the large firms appear impressive.[5]

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5. We have been unable to evaluate the newer quality control systems because, as noted earlier, evidence of substandard performance usually appears only after a client's financial difficulties and then after a long period of time. The results are not yet available. It should be noted that in most of the cases available for study, the substandard performance occurred many years ago.

The existence of large firms influences the ability of the public accounting profession to impose penalties through its self-disciplinary mechanism. As is explained later, the profession's system of imposing penalties on individuals has significant weaknesses, and the profession is not organized in a manner that would enable it to impose penalties on firms. Particularly in the present litigious environment, a voluntary disciplinary mechanism cannot be expected to work very well. However, to a substantial extent the weakness of the profession's self-disciplinary mechanism is offset by the activity of the courts and the SEC and the present or potential strength of state licensing boards. Nevertheless, the profession's self-disciplinary efforts could be more effective and should be strengthened.

TECHNICAL AND ETHICAL STANDARDS

The quality of performance cannot rise above the technical and ethical standards that the individual auditor and his firm strive to meet. The AICPA plays a major role in the development of those standards. The SEC, the courts, state boards of accountancy, and state societies of CPAs also influence standards.

Technical and ethical standards are the product of a long tradition within the profession; their existence predates codification by the AICPA. The process by which individual auditors and firms create standards and apply them to specific situations is enhanced by a strong sense of professional identity. Section 8 considers proposals to encourage that sense of professional identity; section 10 discusses the importance of the establishment by the profession of its own standards.

In 1973 the membership of the AICPA adopted a revised Code of Ethics. These ethical precepts appear to be sufficiently high to meet reasonable user expectations. The Institute's Auditing Standards Executive Committee has recently intensified its efforts to expand the body of authoritative technical standards. Nevertheless, improvement is necessary in the process of establishing auditing standards.[6] In addition, the standard-setting mechanism could and should react more quickly to developing practice problems. To help achieve this, we propose, as discussed in more detail later, that the AICPA analyze audit failures and publish the results on a timely basis.

PRACTICE CONTROLS TO IMPROVE PERFORMANCE AND ASSURE COMPLIANCE WITH STANDARDS

The objectives of quality control procedures are to improve individual and firm performance and assure compliance with technical and ethical standards. Such control procedures are not disciplinary, although their implementation has sometimes been required in connection with disciplinary actions by the SEC.

Recent Activity by Public Accounting Firms

Statement on Auditing Standards No. 4, *Quality Control Considerations for a Firm of Independent Auditors* published in 1974, gave formal recognition to the need for quality control policies and procedures. However, many firms had previously designed and implemented programs for continuing education, second partner and interoffice review of work papers and reports, and other internal quality control policies and procedures. In recent years, those programs have been expanded and improved.

6. Our review of existing auditing standards led to recommendations discussed in sections 2 through 5. Our recommendations for the process of establishing auditing standards are discussed in section 10.

Public Reporting by Accounting Firms. Users of audited financial information appear to rely heavily on the name and reputation of the particular firm performing the audit. This suggests that users are interested in the firm and want more information about it. One firm, Arthur Andersen & Co., has published annual reports for several years and made them available on request. Those reports have received considerable attention, in the profession and in the press. They include financial and nonfinancial data that are roughly comparable to those published by companies whose securities are publicly traded,[7] and they can provide information on the organization and operations of large accounting firms, which may increase the public's understanding.

The Arthur Andersen report is unique and relatively new.[8] No evidence exists as to the extent of its usefulness or effectiveness. However, we encourage experimentation with disclosure of information on a *voluntary* basis without suggesting the precise nature of the data to be disclosed or the format of presentation.

Our encouragement of experimentation with public disclosure is *not* a call for *required* reporting. Accounting firms are privately owned organizations. While there is interest in and possible benefit from information published by public accounting firms, there appears to be no overriding public need for it.[9] Only when the public interest clearly mandates disclosure of information by privately owned businesses should public disclosure of their internal affairs be required. If public accounting firms foresee sufficient benefits to themselves, to the profession, and to the public, they should voluntarily expand their disclosures.

Recent Activity by Professional Organizations

The AICPA and state societies of CPAs have voluntarily taken steps in recent years to establish quality control policies and procedures to encourage compliance with professional standards. Those steps have included the AICPA practice review program, mandated continuing professional education in many jurisdictions, the AICPA local firm quality review program, the AICPA local firm administrative review program, and the AICPA voluntary quality control review program for CPA firms. Similar programs have been imposed on CPAs by the SEC and some state boards of accountancy, and professional disciplinary boards at times have required AICPA members to undertake continuing professional education in response to particular audit failures.

The Effectiveness of Practice Controls

The Institute and individual firms have intensified their activity in the area of quality control in recent years, at least partly in response to a number of highly publicized audit failures. Although the effectiveness of that increased activity cannot be measured at this time, the progress made by both the organized profession and individual firms in designing and instituting control systems and the continuing interest in this area are commendable.

The improvement of quality control policies and procedures is being given active consideration by the entire profession. Although we make no specific recommendations

7. The Arthur Andersen report also includes a report by a public review board established by the firm. The financial statements have not been audited by another firm of independent auditors. However, at the suggestion of its public review board, Arthur Andersen has stated its intention to publish financial statements in 1977 audited by Haskins & Sells.

8. Recently another firm, Touche Ross & Co., published an "annual report" without financial statements.

9. The Commission's study of cases of poor auditor performance and its other research did not provide any examples in which poor performance had any relation to the financial position of the public accounting firm. Nor, in a related vein, could it determine that any useful information would be derived from the required disclosure, by companies or auditing firms, of individual client audit fees.

in this area, particular attention should be devoted to policies and procedures designed to minimize the underlying causes of audit failures such as those identified in our research.[10] As discussed in section 9, the policies and practices of a firm in the areas of practice development, fee determination, time-budgeting, acceptance of deadlines and their combined effect on the quality of work performed should receive increased scrutiny.

PENALIZING SUBSTANDARD PERFORMANCE AND MISCONDUCT

Quality control is only one means of monitoring professional practice. State boards of accountancy, the profession, the courts, and the SEC impose sanctions on individuals or firms for performance or conduct that violates professional standards or civil or criminal laws.[11]

Disciplinary Powers of State Boards of Accountancy

State boards of accountancy are charged with enforcing laws that regulate the practice of public accounting. The boards have the power to revoke or suspend the certificate of "certified public accountant"; to revoke, suspend, or refuse to renew the permit to practice; and to censure the holders of permits to practice. Those penalties can be assessed for a wide variety of acts or omissions specified in accountancy laws. Several states also require the registration of firms and issue permits for firms to practice in the state. Although no state has suspended or revoked a firm's permit, the power to do so exists.

State boards may provide the only means of removing demonstrably incompetent CPAs from public practice. The courts and the SEC cannot always reach them because of the nature of their accounting practice. The National Association of State Boards of Accountancy (NASBA) has recently encouraged greater activity by state boards, but the response to date has generally been limited.

A few state boards have taken innovative and aggressive action to enforce professional standards. For example, some have created teams of investigatory officers to review auditors' work for compliance with accounting principles and reporting standards. As a result of those investigations, individuals and firms have entered into agreements with the state board, consenting, for example, to continuing education, written professional examinations on authoritative literature, and independent quality control reviews. NASBA is exploring the development of a model quality control and enforcement program for state boards.

Greater activity and aggressiveness by state boards could usefully augment the total system of regulating auditors. Since the state boards are reviewing their role, we do not believe it is necessary to make specific recommendations in this area. We do encourage continuing efforts to achieve a reasonable degree of uniformity in state regulation. Uniformity is needed to prevent harmful interference with firms that operate on a national basis with national clients.

The Profession's Disciplinary Mechanism

The profession's self-disciplinary mechanism for individuals consists of the AICPA's

10. The staff analyses of cases involving alleged audit failures are described in appendix B.

11. The SEC imposes sanctions on CPAs under Rule 2(e) proceedings before the Commission. On October 12, 1976, Touche Ross & Co. instituted an action in federal court against the SEC alleging that "Rule 2(e) . . . is invalid and was promulgated by the SEC without any statutory authority" ([Complaint] Touche Ross & Co. v. SEC, Civil No. 76–4489 [S.D.N.Y.]).

Professional Ethics Division, regional trial boards, and a National Review Board.[12] Those bodies are charged with enforcing the bylaws and codes of ethics of state societies of CPAs and the AICPA.[13] The bylaws and codes are enforced through letters of constructive criticism, letters of administrative censure, acceptance of a member's resignation when the resignation is in the public interest, and suspension or expulsion from the AICPA and state society.

Weaknesses in Professional and State Disciplinary Mechanisms

Secrecy of proceedings and results, failure to address significant problems, and inaction during litigation are weaknesses in the state and professional disciplinary mechanism.

Secrecy. Excessive secrecy is a serious weakness in the disciplinary process at both the professional and state level. The effectiveness of the profession's self-disciplinary operation, conducted principally by the AICPA, is significantly weakened by the secrecy surrounding it. The minimal public disclosure usually given to the disciplinary actions of state boards also reduces their effectiveness, but not to the same degree.

The bodies charged with the enforcement of professional self-discipline appropriately do not have the authority to punish erring practitioners with fines or incarceration. In effect, they can impose a single penalty, which is potentitally quite effective. They can publicly denigrate the most valuable asset of a professional, his reputation.

Public condemnation of a professional by his peers can be far more effective than punishment meted out by civil courts or federal or state authorities. Not only is the individual punished, but also other members of the profession are reminded of the rules of professional conduct and performance, a salutory demonstration of the profession's commitment to quality is made to the public, and the public is encouraged to bring ethics violations to the attention of professional bodies.

When professional discipline is conducted in secret, those benefits are lost. The practitioner suffers no significant penalty, other practitioners are not alerted, and the public knows nothing of the profession's commitment to high standards. Moreover, the absence of public knowledge of the disciplinary process and the sanctions imposed probably acts to discourage the reporting of violations.

We are told that the AICPA self-disciplinary bodies conduct themselves in an alert, fair, and careful manner. Accusations against Institute members are carefully considered and the bodies actively search for possible violations. Unfortunately, the existing secrecy has prevented us from meaningfully evaluating the AICPA disciplinary procedures. The initiators of ethics action are not informed of the status of disciplinary proceedings. When results are announced, the name of the member may be withheld and circumstances are described only in the most general terms. The effectiveness of the disciplinary mechanism cannot be evaluated without knowledge of the type and number of complaints that would be brought if the results were more widely known.

Actions by state boards are often technically in the public record, but they are not readily accessible or adequately publicized.[14] Since state boards have authority to levy direct penalties, most commonly affecting the right to practice as a CPA, effective efforts by them may produce some beneficial results. However, punishment of individuals is the

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12. An extensive discussion of the activity of those bodies may be found in Thomas McRae, "AICPA Policies and Programs for Regulating the Auditing Profession and Maintaining the Quality of Practice," August 1976 (described in appendix B).

13. The bylaws and codes of ethics of most state societies are quite similar to those of the AICPA.

14. Recently passed state "sunshine laws" may remove some aspects of secrecy from the disciplinary procedures of state boards but would not directly affect the AICPA's procedures.

least significant goal of the disciplinary process. Greater publicity to state actions could provide useful messages to the rest of the profession and the public.

Secrecy may be necessary during the investigative and deliberative stages of a disciplinary action. Professional reputations are fragile and might be damaged by revelation of allegations that are never substantiated or for which there are adequate explanations. However, once a duly constituted disciplinary body begins its work, those who initiate ethics actions should be informed of the status of the complaint. After that body completes its work, any resulting penalties should be well publicized.

Failure to Address Significant Problems. With a few exceptions, individuals appear to be penalized only for infractions which involve advertising or client solicitation and felony convictions related to the preparation of false tax returns. While not unimportant, those are not major problems facing the profession today. The major problem is substandard performance.

Voluntary and state disciplinary bodies have been reluctant to take strong action against fellow practitioners for substantard work. That may stem in part from the limited variety of penalties the various bodies can impose and their apparent harshness. Except for the most flagrant instances of substandard performance, the cases generally may be too subtle for the relatively primitive disciplinary systems that now exist. Imposing penalties for audit failures requires a highly developed system of fact finding and due process.

Inaction During Litigation. The present policy of the profession's disciplinary bodies is to refrain from taking action against an auditor during litigation to protect individual rights.[15] Since final resolution of litigation often takes many years, disciplinary action is delayed almost indefinitely. Indeed, the delays are so long that sanctions are rarely applied after the litigation, apparently because the infractions have been adequately punished by the courts or sanctions no longer appear relevant.

Reasonable restraint of professional disciplinary action is undoubtedly necessary in the present litigious environment. Information presented in a disciplinary proceeding may be subject to discovery and may be used against a practitioner. Protecting the rights of individuals is a laudable goal, but this should not be allowed to defeat the fulfillment of an important professional responsibility or to result in virtual inaction on the part of the AICPA.

Precise rules of conduct in this area are difficult to formulate, and sensible guides administered by conscientious boards should suffice. At present, there appears to be an almost total presumption against *any* professional action until *all* litigation is resolved. A more reasonable position would be to restrain the profession's disciplinary mechanism only when the member demonstrates that pending litigation is directly related to the misconduct charges and that there is some likelihood that litigation will be unduly influenced by disciplinary action. The burden of demonstrating the need for restraint should fall on the member; the profession should not stay its own hand in disciplinary proceedings.

The disciplinary mechanism should not be restrained during appeals in litigated cases unless the member can demonstrate that the appeal proceeding could result in the introduction of new evidence—on remand, for example—and would be affected by disciplinary action. Appeals usually do not involve or permit new evidence; they consider procedural or legal issues that would not ordinarily be prejudiced by private disciplinary actions. Remand is usually ordered for a stated and, most often, limited purpose.

15. Exceptions to this policy are theoretically possible if the public interest clearly demands that action be taken before settlement of related litigation. This possibility, to our knowledge, has never been invoked.

IMPOSING PENALTIES ON ACCOUNTING FIRMS

The profession's disciplinary process has been criticized for failure to penalize firms. That criticism is technically correct, in the sense that the AICPA has not penalized firms because it does not presently have the power to do so. In contrast to the other elements of self-regulation, penalties against firms are conspicuously absent.

Significance of Inability to Penalize Firms

We do not believe that the AICPA's inability to discipline firms is a critical issue. Punishing a firm is appropriate only when the firm fails to provide or enforce acceptable professional standards; it may not be appropriate when an individual within the firm fails to meet those standards. More important, the overall system does allow significant penalties against firms through court and SEC action, and they have frequently been imposed. Monetary settlements and damages, costs of insurance and legal fees, and unfavorable publicity from SEC actions or litigation are significant penalties against firms for substandard work. As a practical matter, monetary penalties, certain prohibitions against accepting new clients, and bad publicity are the only penalties that can be levied against firms. They appear to be working effectively today.[16] Moreover, our other recommendations for improving the profession's disciplinary mechanism would increase the effectiveness of the profession's ability to penalize individuals.

The profession may be unable to penalize firms, but that is not a weakness in the context of the total system of self-regulation, court and SEC oversight, and other existing mechanisms for dealing with substandard auditor performance.

Limitations of a Voluntary Mechanism

The AICPA is a voluntary professional organization, totally lacking in statutory authority and protections against discovery of information under its existing structure and powers. To discipline firms effectively, the AICPA would have to have the authority and ability to impose penalties on a small number of large firms whose partners and staff would understandably be protective of their own interests. Such action is not feasible, particularly in the present litigious environment. Indeed, there seem to be no other examples of effective professional self-discipline in such circumstances.

It is not surprising that the profession has not created a voluntary system to discipline firms. Noncooperation with a disciplinary proceeding against an individual or a firm would lead, at most, to expulsion of the firm from the voluntary organization. Cooperation, without statutory safeguards, would increase the firm's jeopardy in civil or criminal litigation or SEC enforcement actions, a consequence that is far more significant than expulsion from the AICPA. Given the total legal environment and process, the punishment of individuals and firms at present naturally moves outside the profession to the legal system.

Alternatives to the Present Structure

The present structure, however, is not immutable. An organization could be established within the profession that would have the ability to penalize firms for substandard performance. Such organizations do exist in other areas, for example, the National Association of Securities Dealers. Mandatory membership, authority to make appropriate inquiries, protection against discovery of information, and support and oversight by a governmental agency might all be necessary and would require statutory backing.[17]

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16. The significant effects of litigation are discussed later in this section.

17. Since we did not believe this type of restructuring advisable, we did not devise a complete structure for such an organization. For an example of an alternative to the present structure, see Eli Mason, "A Proposal for Restructuring Our Profession," *The CPA* 45 (July 1975): 19–22.

We have no desire to dampen enthusiasm within the profession to experiment with ways of strengthening the total regulatory process. However, the current tension and rapid pace of change in the profession, although uncomfortable to many practitioners, are an indication that the present structure is reacting and working. We are not convinced that a complete restructuring of the profession is required, for the present system is adequate. Nor do we see any promise that the creation of a regulatory body as described above would be a significant improvement on the present mixture of private and public regulation.

Another alternative is federal chartering of CPAs and registration of firms. This could include a mechanism for a government agency to regulate and penalize individuals and firms for substandard performance. We have considered this alternative to the present system in which the profession, state boards of accountancy, the SEC, and the courts together regulate the quality of practice. It does not appear that a comprehensive federal mechanism for regulating the profession would be superior.

Government, through the courts and the SEC, has had a significant effect on the quality of professional practice. At present, given the significant disillusionment with the federal regulatory structure and scrutiny of the need for federal regulation in many areas, we see no compelling reasons to move the profession completely under federal control. No other major profession in the United States is thus regulated. We believe the present system is working; we know of no evidence to suggest that federal regulation would produce better results.

THE PENALTIES OF LITIGATION AND REGULATORY ENFORCEMENT

Penalties imposed by courts and the SEC overshadow professional self-discipline as means of ensuring adequate performance and professional conduct, and they are probably the most effective purely disciplinary means of protecting the public against substandard auditor performance. As noted earlier, a few state accountancy boards have also begun to show an ability to take actions similar to some of those taken by the SEC.

The Current Legal Climate

The past decade has witnessed a great surge in economic and financial activity and then a period of decline, a period that generated considerable investor disappointment and loss aggravated by the exposure of some notorious financial frauds. Investor and public confidence has also been shaken by disclosure of various forms of corporate impropriety. In cases of financial fraud or impropriety, the independent auditor, often himself a victim of fraud, becomes the target as a defendant from whom substantial damages may be sought. He may also be named a respondent in disciplinary proceedings brought by the SEC or a defendant in criminal proceedings or in civil injunctive actions that seek various forms of ancillary relief.[18]

At a time when our society is increasingly litigious and when no profession has been free of criticism and legal attack, it is not surprising that the independent auditor is also a target. It is understandable that auditors often question whether the legal sanctions to which they have been subjected will allow them to continue to perform with vigor, independence, and efficiency. Inevitably, resentment has been expressed by some auditors against the legal institutions and procedures within which this litigation has occurred.

Class action rules, which enable plaintiffs with limited resources to band together to initiate litigation, reflect an important public policy. A plaintiff who either has no substantial resources or who would not find it economically feasible to pursue his alleged

18. Penalties imposed on auditors through the judicial process and by the SEC are discussed in Henry R. Jaenicke, "The Impact of the Current Legal Climate on the Accounting Profession," July 1976 (described in appendix B).

injury might not be able to obtain redress if class actions were not available. At the same time, the courts have developed liberal rules of discovery that enable plaintiffs to fashion a case from the defendant's own records. Complementing those policies, lawyers have been willing to undertake cases on a contingent fee basis when it appeared that the prospect of recovery was sufficiently attractive to warrant the expenditure of the time and funds necessary to continue litigation to a conclusion. The willingness of defendants and their insurers to settle such litigation out of concerns of uncharted interpretations of law and the cost of trial defense has served to encourage class actions.

Although the rules and procedures that have stimulated the growth of investor litigation are unlikely to undergo substantial change, the pendulum now seems to be swinging from a period of expansive interpretation of provisions that provided liberal access to the courts to a period of greater restraint that limits freedom of access. The Supreme Court, in a series of decisions in the past three years, has changed the direction of litigation under the securities acts. There is, of course, always the possibility, and legislators have recently suggested, that if the courts unduly restrict the bases for investor access to the courts, efforts will be made to legislate a climate more favorable to the plaintiffs.

The Effect of the Current Legal Climate

Litigation and enforcement proceedings do more than merely assess penalties for substandard performance or misconduct. The legal environment affects the profession as a whole as well as the practices of individual auditors and firms. Statutes and court interpretations, SEC enforcement procedures, and litigation influence the auditor's role and responsibilities. We examined the means by which the legal process transmits signals to auditors, and studied how the efficiency and effectiveness of the audit function and the self-regulatory mechanism have been affected by the legal environment.[19]

Legal penalties and public disclosure of them have clearly spurred the profession and firms to reexamine and strengthen technical standards and compliance with them. The AICPA has in recent years issued many authoritative auditing pronouncements, revised its Code of Professional Ethics, and devoted considerable attention to the design and implementation of quality control reviews of firms. Individual firms have also devoted more resources to their own policies and procedures for maintaining the quality of their practice. Some of those procedures were undertaken as a direct result of consent decrees between accounting firms and the SEC. Most of the increased level of activity was a response to a recognized professional obligation, which was spurred only in part by litigation.

Less desirable effects have also resulted from the present litigious environment. The efficiency of litigation, either as a determinant of the auditor's role or as a means of redressing wrongs, is questionable. The investing public indirectly pays probably about three dollars for attorneys' fees, insurance premiums, and other direct and indirect costs of litigation for every dollar awarded to injured plaintiffs.[20] The litigious environment may also reduce the speed with which the profession and firms respond to user requests for auditor association with new types of information.

Some commentators have suggested that because many of the litigated cases involve businesses that have encountered financial difficulties, auditors might become too reluctant to accept marginal companies or new ventures as clients. The suggestion has also been made that increased litigation has led to wasteful "defensive auditing," that is, performing audit procedures that have as their primary purpose providing a defense in the event of later litigation or SEC action. Finally, it is suggested that the litigious environment may discourage able personnel from entering or continuing in the profession.

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19. Jaenicke discusses this subject further in "The Current Legal Climate" (see appendix B).
20. This is an estimate based on data from Jaenicke, "The Current Legal Climate," pp. 87–88.

We have found no evidence to suggest that those three conditions exist to a significant extent. On the contrary, there is considerable competition to obtain new or expanding entities as clients. "Defensive auditing" seems to entail little more than appropriate documentation of audit procedures or more careful selection of items to be tested. High quality students are seeking positions in the profession in increasing numbers, and few persons are known to have left audit practice because of the risk of litigation.

However, the litigious environment seems to have made auditors reluctant to accept expanded responsibilities. For example, part of the profession's resistance to auditor association with new types of information such as forecasts reflects concern about greater exposure to legal liability.

The suggestion has also been made that the profession has been unwilling to define auditing standards more rigorously because of the fear of providing a basis for additional litigation. D. R. Carmichael has noted that "as the amount of litigation against auditors and the size of potential damages increased, auditors became more cautious about describing their responsibilities in authoritative pronouncements and CPA firm manuals."[21] John Carey stated in 1969 that the AICPA "has become increasingly aware that pronouncements and rules which encourage higher standards of performance might be used against its members unfairly in the courts."[22] This appears to have been particularly true with regard to the auditor's responsibility for the detection of fraud.

Recommendations for Changes in the Legal Environment

While there have been some undesirable effects from the litigious climate, it has effectively spurred the profession and individual firms to augment existing mechanisms to maintain or improve the quality of practice and to create new ones. On balance, we do not believe that major changes in the legal environment would produce significant benefits to society or to the profession. However, some improvements can be made.

Analyzing and Reporting Audit Failures. Our largest expenditure of staff resources was in cataloging and analyzing major recent civil, criminal, and SEC enforcement cases involving alleged audit failures. No such analysis had previously been done by the AICPA or other organizations which could make the results available to the profession or to us.

The profession, like the Commission, requires thorough analyses of cases of audit failure if it is to understand problems and develop corrective procedures. Therefore, the AICPA, with the cooperation of accounting firms and through the use of court and SEC documents, should establish a mechanism for timely and continuing analyses of individual cases as they move through the judicial or regulatory system. The analyses should be published in a form readily available to practitioners, teachers, and others. They should consider the nature and causes of specific audit failures, the changes in auditors' responsibilities suggested by litigation and SEC administrative action, and the implications for the auditor's evolving role. Because they would be descriptive of actual court rulings, settlements, or enforcement proceedings and not normative or disciplinary, they need not await the outcome of related disciplinary proceedings by professional bodies.

Assessment of Costs Against Unsuccessful Plaintiffs. Several sections of the federal securities acts permit the courts to assess costs—including defense costs—against plaintiffs and to require plaintiffs to post bonds for those costs. An extension of this power, such as that proposed in the American Law Institute's *Federal Securities Code,* to all

21. D. R. Carmichael, "The Independent Auditor's Responsibility for the Detection of Fraud," 1975 (described in appendix B).

22. John Carey, *The Rise of the Accounting Profession,* 2 vols. (New York: AICPA, 1969), 1:248.

sections of the securities acts that permit private litigation for monetary damages would serve to discourage "nuisance" or "strike" suits against auditors. The ability of the court to assess costs against unsuccessful plaintiffs would not restrict plaintiffs' access to the judicial process. The court would be empowered, but not required, to assess costs. That power could be used with discretion by the court when, by objective standards, the complaint was frivolous or had little chance of success at trial. We recommend that appropriate legislation be enacted and support the direction that the American Law Institute has taken on this matter.

Statutory Limitations to Damages. The potential liability of an expert—including an auditor —under Section 11 of the Securities Act of 1933 is the entire offering price of the public offering. Class actions under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 have sought damages equal to the decline in the market value of all of the outstanding shares of an issuer. This exposure is far out of proportion to the possible gain the auditor could have received, namely the audit fees from a particular client. Various proposals have been advanced for a statutory limitation to the monetary damages that could be recovered from auditors. The American Law Institute, under the direction of Professor Louis Loss and with the assistance of other noted legal scholars, has considered this issue in its proposed *Federal Securities Code* and has advanced specific proposals for the limitation of damages.

We believe that some form of statutory limitation of monetary damages is essential to the continued healthy existence of the public accounting profession in the private sector. Increasing insurance costs, and even the possibility that significant insurance coverage may not be available in the future, may place an intolerable burden on private accounting practice. We therefore endorse the American Law Institute's efforts to find a solution to the excessive financial exposure faced by auditors and other professionals. However, we do not endorse any specific liability limit. Potential liability should be high enough to provide significant penalties and redress, but some limit is necessary.

Increased Use of Court Appointed Masters. Civil and criminal actions against auditors generally involve complicated points of accounting, auditing, and law. A judge, and if the action is resolved through a jury trial, the jurors as well, will often be expected to understand accounting principles and auditing standards and their application in specific circumstances. Subtle points of law must be explained in the judge's charge to the jury. Some auditors and lawyers have suggested that the burden this places on the judge and jury system is unreasonable and have proposed the use of court appointed "masters" in complicated cases.[23]

Masters would be particularly appropriate when the evidence is too complex for a jury to understand and the judge concludes that he, too, does not have the necessary background and experience. One court recently denied demands for a jury trial in an antifraud case because the accounting issues were too complex for jury determination.[24] The court stated "the factual issues, the complexity of the evidence that will be required to explore those issues, and the time required to do so leads to the conclusion that a jury would not be a rational and capable fact finder." The judge noted his "experience in presiding over other complicated cases involving commercial matters." In other circumstances, a judge might determine that he did not have the necessary background and experience. He might then turn to the use of a master in a fact-finding capacity.

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23. See, for example, H. B. Reiling and R. A. Taussig, "Recent Liability Cases: Implications for Accountants," *The Journal of Accountancy* (September 1970): 39–53.

24. *In Re* Boise Cascade Securities Litigation, 420 F.Supp. 99 (D.C.W., Wash., 1976).

Several precedents and analogies support the use of masters in litigation involving auditors. The Federal Rules of Civil Procedure permit their use in district courts, with the judge having considerable discretion over the type of material referred to them. Reiling and Taussig cite as one example the use of a master to supervise the taking of minutes that produced findings on accounting questions. In another case involving antitrust litigation, the extremely complex assessment of damages was referred to a special master who conducted hearings and reported his findings to the court.[25] A master would be expected to have the expertise comparable to that of an SEC administrative law judge. We endorse the increased use of masters to make impartial expertise available to the court.

Limited Extension of the "Safe Harbor" Concept. The profession has been reluctant to become associated with new types of information such as forecasts and various forms of current values. Part of this reluctance can be traced to fear of creating new bases for litigation. The granting of an appropriate "safe harbor" by either legislation or SEC action, similar to that adopted by the SEC relating to replacement cost disclosure, could remove one significant impediment to professional involvement in such matters. A safe-harbor rule provides protection by placing on the person seeking to establish liability the burden of proof that a certain specified standard was not met.[26]

Safe harbors should be made available only when auditors are asked to assume new responsibilities or significantly extend old ones. The safe-harbor device would be appropriate only when the proposed extension represents a sharp increase in the level of responsibility or involves new, untried, high-risk areas. After an appropriate period of experience with the new type of information, the continued need for the safe harbor should be reconsidered. Society would be better served if auditors were more often involved with new types of information. Such involvement will serve to improve the quality of such information and hasten the development of improved standards. The involvement would be more likely to occur if standards for proper auditor conduct could be agreed on in advance that would serve as a means of limiting liability if the auditor has performed in a reasonable manner.

25. Trans World Airlines, Inc. v. Hughes, 308 F.Supp. 679 (U.S.D.C., S.D.N.Y., 1969).

26. See, for example, the language of the safe-harbor rule in SEC Accounting Series Release No. 203, "Notice of Adoption of Amendment to Rule 3–17 of Regulation S-X, Relating to Disclosure of Certain Replacement Cost Data," December 9, 1976.

APPENDIX

A Reconciliation of Statement of Issues and Report of Tentative Conclusions

In September 1975 the Commission published a *Statement of Issues* to explain to interested parties the matters that it was considering. This *Report of Tentative Conclusions* includes discussions of the matters listed in the *Statement of Issues,* but the order of presentation differs. The matters identified in the *Statement of Issues* are considered in the sections of the *Report of Tentative Conclusions* as indicated in the following table.

Statement of Issues	*Report of Tentative Conclusions*
General Issues:	
G-1. The Role of the Independent Auditor	Sections 1 and 6
G-2. Gap Between Performance and Expectations	*
Phase I. The Auditor's Present Responsibilities:	
I-1. Forming an Opinion on Financial Presentations	Section 2
I-2. Clarifying the Responsibility for the Detection of Fraud	Section 4
I-3. Reporting on Uncertainties	Section 3
I-4. Detecting and Disclosing Adverse Management Behavior	Section 5
I-5. Improving Communication in the Auditor's Standard Report	Section 7
I-6. Improving Auditing Methods and Techniques	**
Phase II. Extensions of the Auditor's Role:	
II-1. New Forms of Reporting	Section 6
II-2. Evaluating the Relationship of Nonauditing Services to the Audit Function	Section 9
Phase III. The Institutional Framework of the Audit Function:	
III-1. Organizational Structure for Regulating the Profession	Section 11
III-2. Policies and Procedures for Maintaining the Quality of Audit Practice	Section 11
III-3. Process of Establishing Audit Standards	Section 10
III-4. Developing Individuals as Independent Auditors	Section 8
III-5. Relationships Between the Auditor and Parties Interested in the Audit Function	Sections 1 and 9
III-6. The Legal Environment of Independent Auditors	Section 11

* Specific aspects of Issue G-2, "Gap Between Performance and Expectations," are considered when relevant throughout the report, particularly in sections 1 through 7.

** Aspects of Issue I-6, "Improving Auditing Methods and Techniques," were considered when relevant in considering issues discussed in sections 4, 5, 6, and 9.

B APPENDIX
Summaries of Research Projects

This appendix presents descriptions of the Commission's research projects and brief summaries of the results. The Commission used these materials in developing its conclusions and recommendations. However, the conclusions expressed in the various papers and studies are those of the researchers and authors, not those of the Commission.

The four types of research projects consist of (1) background papers, which were prepared by the Commission's staff and consultants, (2) conferences and interviews, which were conducted or sponsored by the Commission and its staff, (3) staff analyses of cases involving alleged audit failures, and (4) surveys, which were conducted for or sponsored by the Commission. The descriptions of the projects are presented for the convenience of the readers of the Commission's report under those categories and in that order. The materials summarized are available for inspection in the AICPA library at 1211 Avenue of the Americas in New York City. The following is a list of the projects described, arranged alphabetically by author or title of project, which shows the location of each description for convenient reference.

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BACKGROUND PAPERS

Auditing Standards Division

Auditing Standards Division: Responsibilities, Authority and Structure and *Projects Presently in Process or Completed by the Auditing Standards Executive Committee (September 1965-January 1975),* two memoranda prepared by the staff of the Auditing Standards Division in 1975.

Two memoranda provide background information on the operations of the AICPA's Auditing Standards Division. The first describes the objectives, responsibilities, functions, and authority of the division and presents information on its structure, composition, output, and agenda at that time. The second lists the projects undertaken by the Auditing Standards Executive Committee over the ten-year period 1965 to 1975 and identifies the inception, objectives, and disposition of those projects.

The Auditor's Role

Mautz, R. K., *The Role of the Independent Auditor in a Market Economy,* a Study Paper Prepared for the Commission on Auditors' Responsibilities, June 30, 1975, 60 pp.

The paper develops a framework for selecting activities appropriate to independent CPAs, for excluding activities from the range of permissible services, and for assigning priorities for those retained. A suggested ranking of services on the basis of their relative social importance uses six weighted criteria: competence, performance, demand, breadth of benefit, public/private usefulness, and exclusive competence.

The author suggests several general conclusions. No simple definition of role can solve the problems facing independent auditors. Role is a complex of functions and relationships determined by environment, opportunity, competence, and public acceptance. The "classical" description of role emphasizes one service to the exclusion of others and largely ignores the significance of the relationships between auditors and the various other interests in their work.

All relationships in the performance of the audit function include some threat to real independence, apparent independence, or both. Neither restriction of duties nor revision of relationships nor any feasible combination of these provides complete assurance of independence in fact. To reduce the incidence of incompatible functions and the threats to real and apparent independence, the profession can make effective use of a number of measures including an increased professional emphasis in accounting education at the university level, on-the-job training and continuing education courses, quality control measures and clear separation of functions within public accounting firms, effective disciplinary measures, independent corporate audit committees, and an educational program to inform the concerned public (including students) of the existence and effectiveness of measures to strengthen audit independence.

Mautz, R. K., *The Role of Auditing in Our Society,* October 1975, 19 pp.

This paper treats the role of the auditor in our society under thirteen headings: the need for financial data, financial statement reliability, independent examination of financial statements, other services provided by auditors, misunderstanding of assurance provided, early development of open market conditions, decline of open market conditions, expansion

of the securities market, increasing influence of financial analysts, recent SEC activity, education for the profession, possible influence of the corporate morality problem, and need for additional attention to auditing. The author concludes that while the role of auditing can be simply stated as adding credibility to financial statements, this does not describe the true complexity of that role nor its importance. He points out that reliability in financial data is essential in a society that depends on market activity for resource allocation and that financial statements are subject to a variety of infirmities from simple mathematical mistakes to faulty assumptions about the future, from unintentional errors in judgment to deliberate misstatement of facts, from inadequate disclosure of important matters to excessive detail. He notes that both technical expertise and substantive independence from both users and suppliers of financial statements are essential for judging the reporting organization's condition, progress, and success; that the expertise possessed by most auditors is based on a combination of audit experience and on-the-job training superimposed on a formal undergraduate education which includes liberal, general business, and accounting elements; that the appearance of independence is shadowed by the fact that the auditor's fee is paid by the company audited and that auditors perform management advisory services. He also concludes that the increasing tendency to litigate against auditors, the current consumer emphasis, the increased responsibilities of professionals in the securities industry, and extended reporting and auditing requirements all increase audit costs to clients as well as the social cost of the services auditors provide.

Wiesen, J., *Congressional and SEC Expectations Regarding Auditors' Duties,* December 1976, 112 pp.

The author examines congressional intent regarding accountants in their role as auditors, principally at the time of enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, to ascertain the nature and extent of responsibilities that Congress intended auditors to assume when the securities acts were passed. The paper investigates the duties that Congress expected auditors to perform, reviews perceptions of the SEC's "unfulfilled" expectations of the work of auditors, and compares and contrasts those perceptions to the description of congressional expectations.

The author assembles evidence and develops arguments to show that Congress did not carefully consider the auditor's role during the legislative hearings on the 1933 and 1934 securities acts. He finds that the evidence of congressional consideration is sparse and is consistent with both generally high and generally low expectations. However, congressmen displayed a lack of knowledge about auditing and "less than vigorous" interest when the topic was raised in the hearings. The failure of Congress to consider auditors' duties carefully tends to rebut arguments that Congress was placing heavy responsibilities on auditors. "The creation of the SEC in 1934 appears to have been an extravagant substitution for profound thinking about the duties of auditors." He finds that the SEC's expectations of auditors is at a "high" rather than a "low" level, "presumably on the theory that emphasizing the limitations of auditing presented to Congress in 1933-34 would be inimical to the SEC's present protective and remedial roles." He also finds several possible conflicts in a comparison of congressional expectations to the present "unfulfilled" expectations of the SEC.

Communication With Users

Aranoff, T. D., *The Auditor's Standard Report,* August 20, 1975, 47 pp.

The author presents a review of the historical evolution of the auditor's report in the United States, a summary of the criticisms of the present form of the report, a discussion of

two alternative approaches (expansion and reduction) of revising the report in response to the criticisms, an analysis and critique of the individual phrases and parts of the report, a discussion of other methods of communicating with users, and a summary of the types of reports used in other countries.

The auditor's report in the United States has evolved through seven identifiable stages to its present form. A standard form of report was first recommended in 1933 for companies listed on the New York Stock Exchange and was adopted in 1947 for general use in its present form. It has been widely criticized as an inadequate and misunderstood form of communication.

Both expansion and reduction have been proposed as approaches to revising the report to respond to criticism. The most serious effort has been in the direction of expansion. The Institute's Committee on Auditing Procedures undertook a major effort, which spanned the years 1965 through 1972, to revise the report. The committee's efforts failed not for the lack of a consensus on a revised report but largely because of environmental influences.

Epstein, M. J., *The Corporate Shareholder's View of the Auditor's Report* (undated, 1976), 19 pp.; *The Corporate Shareholder's View of the Auditor's Report: Conclusions and Recommendations* (undated, 1976), 3 pp.; and *Analysis of Open-Ended Responses to Questionnaire* (May 1976), 3 pp.

These papers are based on the results of earlier research conducted by the author. In 1975, Professor Marc J. Epstein published the results of a study on the readership of corporate annual reports that he had begun in 1971 (*The Usefulness of Annual Reports to Corporate Shareholders,* California State University, 1975). In that study, he distributed a questionnaire to a stratified random sample of 1,977 shareholders owning at least one round lot of stock listed on the New York and American Stock Exchanges and received 432 useable responses. The survey showed that 25.2 percent of respondents read the auditor's report somewhat thoroughly, 21.5 percent found it difficult to understand, 13.3 percent found it somewhat useful in their investment decisions, and 13.9 percent expressed a desire for additional information about it. In the papers prepared for the Commission, the author analyzes the implications of the results of the study for communication in the independent auditor's standard report. He analyzes the results in several ways: according to the sophistication of the respondents, based on age, wealth, and education; according to their investment goals; and according to their preferred sources of investment information. Views tended to be independent of investment goals and preferred sources of information. Respondents who in terms of some of the criteria were "sophisticated" tended to find the report more useful than others. The author concludes that "shareholders are not interested in the details of an audit" but "are looking for a seal of approval."

Seidler, L. J., *Symbolism and Communication in the Auditor's Report,* 1976, 24 pp.

The author describes the complex communication embodied in the independent auditor's report and hypothesizes that both the so-called unsophisticated investor and the sophisticated investor view the report as a symbol. He examines the nature and use of symbols and discusses some of the implications arising from the concept of the auditor's opinion as a symbol. Among the suggested implications of considering the auditor's opinion as a symbol are that small changes in wording would not communicate any more than the present symbolic meaning and that only significant changes in form and substance

can communicate differently from the original symbol. The author concludes that any intended change in the meaning of the auditor's report should be accompanied by a clearly visible change in the size and shape or other makeup of the report.

Cost-Benefit Study

Shakun, M. F., *Cost/Benefit Study of Auditing: Preliminary Report for the Commission on Auditors' Responsibilities,* March 1976, 28 pp.

The author presents an explanation of possible theoretical approaches to cost-benefit analysis of the audit function from the level of the firm and from the level of the economy as a whole. The basic premise is that the costs of information errors, which result in inefficient allocation of resources, can be balanced against the cost of auditing, which reduces information errors, so as to obtain an optimum relationship. An approach based on capital budgeting and portfolio theory is considered at the level of the economy as a whole. An approach based on linear programming is presented to illustrate how information errors affect resource allocation at the level of the individual firm. Also discussed are possible ways in which individual auditing firms can use decision-theory methods to balance the cost of auditing against a user's expected loss in deciding with erroneous information. A specific illustration of the use of game theory is presented.

Effectiveness of Audit Techniques

Price Waterhouse & Co., Memorandum to Commission on Auditors' Responsibilities, *Effectiveness of Auditing Methods and Techniques and Possibilities for Improving Effectiveness,* July 1975, 25 pp.

The paper reviews auditing concepts and philosophies and discusses audit evidence, its use, and the techniques of gathering it as background for analyzing the effectiveness of auditing methods and techniques. It reviews certain aspects of auditing history, analyzes the effect on the audit process of financial statement objectives and environmental considerations, considers and classifies audit evidence, and discusses testing techniques including the process of selecting test samples. The findings of the paper are that most problems relating to the effectiveness of auditing techniques do not stem from the failure of the techniques themselves but rather from the environment in which auditors function and from unrealistic expectations.

Expectations of Users

Davidson, L., *The Role and Responsibilities of the Auditor: Perspectives, Expectations and Analysis,* 1975, 96 pp.

Using answers to specific questions from nine surveys that were conducted from 1964 to 1974, the author analyzes the expectations and interpretations of the auditor's role by various users. The surveys include the Andersen Survey of 1974, the Beck Survey of 1972, the Lee Survey of 1970, the Hartley and Ross Survey of 1972, the Titard Survey of 1971, the Briloff Survey of 1965, and the Schulte Survey of 1964. The subjects interpreted by these surveys are the auditor's responsibility in forming an opinion on financial statements and the role of "generally accepted accounting principles" in that judgment process; the responsibility of the auditor for the detection of fraud; extending the auditor's role in reporting on new forms of information such as interim financial statements, and in reporting on other activities and characteristics such as the efficiency of operations or the adequacy of internal control systems; the responsibility of the auditor for detecting illegal acts by management and for disclosure of such behavior to interested parties; the relationship of the independent auditor

to investors, creditors, the board of directors and its audit committee, management, and other interested parties; the effect of nonauditing services on the audit function; and the role of the auditor's report in communicating with users of financial information. The author concludes that all of the surveys had serious defects in their construction and design and in most cases presented confusing answers to the questions raised by the foregoing subjects. He feels, however, that the survey method is useful and that there are now sophisticated methodologies available to produce well-designed surveys of value to the accounting profession.

Fraud

Carmichael, D. R., *The Independent Auditor's Responsibility for the Detection of Fraud,* 1975, 44 pp.

The author probes the question, Should the independent auditor be held responsible if his ordinary examination of financial statements fails to detect a material fraud? He then defines the basic terms used, noting that fraud is a legal term meaning an act of deceit resulting from misrepresentation of a material fact with knowledge of its falseness or with lack of reasonable grounds to believe it to induce reliance by another, thus causing him damage. Management frauds usually arise from fictitious transactions, transactions without substance with undisclosed related parties and undisclosed risks and liabilities, and misapplication of accounting measures and conventions. The author then follows the evolution of fraud in accounting literature as a major objective of the audit in the 1900s, when it was considered the first of such objectives, to the Statement on Auditing Standards No. 1, section 110.05, which says, "The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from noncompliance with generally accepted auditing standards." This is an inadequate approach to defining the auditor's responsibility because it does not specify what frauds an examination in accordance with generally accepted auditing standards is designed to detect. The author then considers possible approaches to specifying the auditor's responsibility for detection of fraud and concludes that none of them appears adequate. He concludes that the profession must take a new position on the auditor's responsibilities in this area, making several value judgments that take into account, among other considerations, the cost of the additional audit work necessary, the likelihood of success in the search for fraud, and the probability of occurrence of various material errors and irregularities.

Illegal Acts

Label, W., *The Auditor's Responsibility for Adverse Management Behavior,* undated, 35 pp.

The author examines the auditor's responsibility for the detection and disclosure of illegal acts of clients, primarily from a historical perspective. He reviews official statements or actions on the problem by professional bodies in the United States and in the United Kingdom and develops possible alternative formulations of the auditor's responsibility in the area. Responsibility for the *detection* of illegal acts is distinguished from responsibility for the *disclosure* of illegal acts.

Judgment in the Application of GAAP

Jaenicke, H. R., *The Need for Judgment in the Application of Accounting Principles,* July 1975, 19 pp.

The author explores the extent to which authoritative literature incorporates the exercise of judgment in the concept of generally accepted accounting principles (GAAP)

and the extent to which the further enunciation of specific principles for varying circumstances is desirable. He searches the authoritative literature for general expressions of the need for judgment and specific requirements for the exercise of judgment both in relation to accounting for specific events and transactions and in the selection of accounting principles.

He finds that judgment is an essential element of GAAP; achieving uniformity by eliminating alternatives will not produce either comparability or fairness of presentation in conformity with GAAP as both require that the substance of transactions and the circumstances in which they occur be recognized. General expressions of the need for judgment in the selection and application of accounting principles are either explicit or implicit in numerous authoritative sources. The application of Rule 203 of the AICPA Code of Professional Ethics specifically requires the exercise of judgment. Numerous examples of requirements to exercise judgment in accounting for specific events and transactions are found in the literature. Examples from APB opinions, FASB statements, APB interpretations, and AICPA accounting and auditing guides are presented.

Legal Climate

Jaenicke, H. R., *The Impact of the Current Legal Climate on the Accounting Profession*, July 1976, 159 pp.

In this paper the author considers various aspects of the auditor's legal environment, analyzes their effect on society and on auditors, evaluates proposals for change in the legal environment, and recommends several changes. He considers the broad social influences contributing to increasing litigation against auditors in terms of the growth of consumerism, various theories that view the auditor as performing an insurance role, and the increasing public awareness of independent auditors. An analysis of the auditor's increasing exposure to liability to third parties under common and statutory law considers the pertinent cases, the concept of scienter, and certain procedural aspects of litigation including class actions and contingent fees. Other significant sanctions against auditors reviewed include criminal, injunctive, and administrative proceedings. Sections of the American Law Institute's proposed Federal Securities Code are reviewed and evaluated. The impact of the legal environment on the efficiency and effectiveness of the audit function is analyzed from the perspective of society, the auditing profession, and individual auditors. Proposed methods for changing the legal environment are evaluated against the background developed.

The author finds that the evidence indicates that the litigious environment in which auditors have functioned in recent years has produced both good and bad effects and that there is no firm evidence that the overall effect has been negative. Acceptable proposals for specific change, however, should enhance desirable or alleviate undesirable consequences and thereby produce a net increase in the economy and effectiveness with which individual auditors carry out their assigned role in society. Thus, acceptable changes should not be directed at the aggrandizement of individual auditors, should not seek to relieve the auditor of the liability for substandard performance, and should not seek to alter the overall judicial system. Acceptable proposals for changes in the legal environment that merit the support of independent auditors are identified and recommended.

Legal Protection From Compliance With GAAP and GAAS

Radoff, P. L., *Court Decisions on Auditors' Liability: The Role of GAAP and GAAS*, 1975, 48 pp.

This memorandum considers the extent to which the courts have permitted auditors to prevail in invoking the defenses of conformity with generally accepted accounting principles

(GAAP) and compliance with generally accepted auditing standards (GAAS) in civil and criminal cases at common law and under the securities acts. *United States* v. *Simon* (425 F.2d 796, 2d Cir., 1969) is analyzed as the landmark case restricting the availability of the defense of conformity with GAAP. The author finds that *Simon* establishes that compliance with GAAP does not necessarily assure fairness and that the ultimate determination of fairness of presentation rests with the trier of the facts, although the question of compliance with formally established principles was left open. However, the case provides no assurance that compliance with formally established rules will always require a finding of fairness. The proposition accepted in *Simon* is not a departure from prior case law; the courts have generally rejected the proposition that compliance with GAAP alone is an adequate defense for auditors in either civil or criminal cases.

The author reviews *Hochfelder* v. *Ernst & Ernst* (503 F.2d 1100, 7th Cir., 1974), then pending before the U.S. Supreme Court, and *Pacific Acceptance Corp.* v. *Forsyth (92 W.N.* (N.S.W.), 29, 1970), an Australian case, as two cases which have addressed the question of whether an auditor may be held to an investigatory standard higher than that recognized by the profession. He finds that *Hochfelder* tends to support the proposition enunciated in *Escott* v. *BarChris Constr. Corp.* (283 F.Supp. 643 [S.D.N.Y.] 1968) "that the auditor's duty of inquiry is determined by professional standards," whereas *Pacific Acceptance* expresses "an explicit disapproval of GAAS as a limitation on the scope of the auditor's duty." Nevertheless, he concludes that reliance on specific auditing standards may provide a substantial measure of protection and that the relative safety of formally adopted standards and the relative uncertainty of behavior not expressly covered by formal standards provide an incentive for the profession to continue to adopt explicit standards.

Objectives of Financial Statements

Seidler, L. J.; and McConnell, P., *Report of the Study Group on the Objectives of Financial Statements: Its Relationship to the Commission on Auditors' Responsibility*, 1975, 27 pp.

The paper reviews the findings of the Report of the Study Group on the Objectives of Financial Statements (Trueblood committee) to assess the implications for the work of the Commission. As background, it reviews the reasons for establishing the Objectives Study Group and its relationship to the Study Group on Establishment of Accounting Principles (Wheat study group), the purpose of the study, the expectations of various groups at the time the study was commissioned, and the subsequent consideration of the report by the Financial Accounting Standards Board (FASB) as a part of its project on the conceptual framework.

Reporting on Internal Controls

Brown, M. V., *The Auditor and Internal Controls: An Analyst's View,* October 1976, 23 pp.

The author, a chartered financial analyst, considers the issues of public reporting on internal controls and the extension of the independent auditor's responsibility to include reports on internal controls. She discusses the growing awareness of the importance of adequate internal controls, including the effect of recent disclosures of major financial failures, demands for information on internal controls by banks and other private investors, recent disclosures of foreign bribes and other questionable payments, and proposed legislation that would require adequate internal controls; the materiality of internal controls in the investment decision-making process, including the nature of the process and the materiality tests that should apply; and the nature of the auditor's statement on internal control, including the definition of internal controls, the form for a

report on internal controls, and the standards to be applied. As part of the background for the paper, the author conducted telephone interviews with twenty-two investment professionals at the executive level and five security analysts.

The author developed arguments to support the major conclusion of the paper that management should issue public reports on internal controls, broadly defined to include administrative as well as accounting controls, and that the independent auditor should issue an opinion on the report and take responsibility for judging the adequacy of disclosures in the report the same as he now does for financial statements. She contends that asking the auditor to assume a role in reporting on internal controls similar to the role that he now assumes in reporting on financial statements may, under closer examination, prove not to be a new role at all.

Scope of Study

Harlan, S. D., Jr.; Elliott, R. K.; and Lea, R., *Some Thoughts on Subject Matter and Approach,* January 1975, 9 pp.

This unsolicited paper presents suggestions on the scope, direction, and output of the Commission's study. The authors list and explain some of the basic needs in auditing, suggest primary and secondary subject matter for the study, and suggest research and other procedures for the study. They conclude that the Commission should produce a statement describing the desired role of the auditor in American society, identify areas of practice that fail to fulfill the desired role, and recommend mechanisms that should be established in the profession to facilitate the timely resolution of auditing problems in light of current conditions and trends in society.

Self-Regulation

McRae, T. W., *AICPA Policies and Programs for Regulating the Auditing Profession and Maintaining the Quality of Practice,* August 1976, 66 pp.

This study begins with a broad perspective on self-regulation. The author then describes the Institute's Code of Professional Ethics and the Professional Ethics Division established to implement it. He deals with the Joint Trial Boards and National Review Board, disciplinary actions, and investigative and educational activities. He evaluates this program as to its weaknesses and strengths and concludes that the continuing efforts to improve the system are evidence that the profession is alert to the needs and expectations of those who depend on the integrity of independent auditors.

The author describes and evaluates the AICPA's practice review program and the local firm quality and administrative review programs, SEC-mandated reviews, quality control procedures for multi-office firms, and the proposed review program for CPA firms with SEC practices. The author also considers the AICPA's influence on programs and standards for professional education. He discusses professional schools of accounting, the AICPA's continuing professional education program, and the CPA examination. The author points out that the AICPA is only one of the organizations and social forces regulating the profession and that effective regulation requires authority that cannot easily be flaunted and penalties that are appropriate to the offenses.

Uncertainties

Carmichael, D. R., *Risk and Uncertainty in Financial Reporting and the Auditor's Role*, 1976, 47 pp.

This paper studies the "subject to" qualifications as used in attempting to indicate various forms of risk or uncertainties in financial statements. It opens by illustrating a

number of problems in the reporting of risks and uncertainties through an analysis of several well-known cases. The author discusses the purpose of the "subject to" qualification, notes the distinction between information risk, the risk of distortion or misinterpretation arising from the process of accumulating, summarizing, or presenting information—a risk which the auditor must do his best to eliminate—and business risk, which is inherent in an uncertain and open economy and represents the risks investors naturally assume in business activities and which the auditor can do nothing about. It is in his efforts to reduce information risk that the auditor must find a sound way of portraying risks and uncertainties. The author discusses the FASB Statement No. 5, clarifying when to record and when and what to disclose in the matter of contingencies and the SEC's Release No. 166 on disclosure of uncertainties and their implications for the auditor's role.

The author concludes by recommending that the requirement to issue a "subject to" qualification be eliminated and that the type of disclosure recommended by the SEC in ASR No. 166 be implemented on a wider scale.

McRae, T. W., *The Independent Auditor's Role in Assessing Uncertainties,* March 1975, 53 pp.

This study discusses the nature and impact of uncertainties in financial statements, indicates the alternate levels of responsibility that the independent auditor might assume, and notes the considerations which must be taken into account in establishing the auditor's responsibility. The author discusses measurement and reporting requirements under generally accepted accounting principles and generally accepted auditing standards, noting the treatment of a qualification in circumstances in which the existence of uncertainties raises doubts as to the ability of the business to continue in operation, as treated in Accounting Series Release No. 115. The author then appraises auditing standards as they apply in ordinary and in unusual uncertainties and discusses the *Herzfeld* v. *Laventhol* case in which the court concluded that Laventhol was under an obligation to reveal its reservations and the facts upon which those reservations were based, even though the auditors had issued an opinion with an uncertainty qualification.

CONFERENCES AND INTERVIEWS

Chairman of New York Stock Exchange

A staff memorandum (3 pages) reports the result of an interview with James Needham, then chairman of the New York Stock Exchange, by the chairman of the Commission on Auditors' Responsibilities and two staff members.

Chief Accountants of Federal Agencies

The written material consists of a staff memorandum, *Summary of Views Presented at the June 2, 1975 meeting of the Commission on Auditors' Responsibilities with the Interregulatory Accounting Committee (Chief Accountants of Federal Agencies)* (11 pages) and a memorandum prepared by the Federal Audit Executive Council, *Major Issues Concerning Auditors' Responsibilities* (34 pages). Twelve chief accountants of federal agencies appeared before a meeting of the Commission to discuss their views on the problems confronting independent auditors. The staff memorandum identifies the participants and their agencies and summarizes significant views. The memorandum prepared by the Federal Executive Council presents a summary of views from various federal agencies on each of the major issues identified by the Commission.

General Accounting Office

A staff memorandum (4 pages) presents highlights of a meeting of the Commission with representatives of the General Accounting Office in Washington, D.C. on June 3, 1975, to discuss the problems confronting independent auditors. The memorandum summarizes the views expressed by the representatives of the GAO, who stressed the need to expand the role of the independent auditor to encompass reporting on the efficiency, economy, and effectiveness of business enterprises and government programs.

Representatives of the American Institute of Architects

A staff memorandum (2 pages) reports the result of a meeting of two staff members on June 11, 1975, with representatives of the American Institute of Architects and their insurance broker to obtain information on litigation against architects and on their liability exposure.

Representatives of Accounting and Legal Professions and Business in Canada

The written material consists of a staff memorandum presenting a summary of views expressed at a meeting of the Commission in Toronto on July 9-10, 1975, and written submissions of participants. Written submissions consist of memoranda dated July 10, 1975, from R. J. Anderson (11 pages); John G. Arthur, with enclosures (11 pages); Warren Chippindale (6 pages); Stephen Elliott, with enclosures (21 pages); K. S. Gunning (12 pages); William A. Harshaw (5 pages); D. G. Keaveney, with enclosures (17 pages); A. J. MacIntosh (9 pages); Paul E. Mallette (7 pages); E. H. Orser (1 page); Ronald R. Smith (18 pages); and J. R. M. Wilson (3 pages).

Representatives from the following six groups appeared separately before the Commission: representatives of securities commissions and stock exchanges; senior members of the accounting profession; members of the legal profession; practicing auditors; representatives of industry, banking, and financial analysts, and representatives of the Canadian auditing standards committee.

Representatives of Accounting and Legal Professions and Business in the United States

Distinguished accountants, financial executives, financial analysts, lawyers, bankers, and academicians appeared before the Commission over a three-day period (March 5, 6, and 7, 1975) to present their views on the major issues confronting independent auditors. The views expressed are summarized in a staff memorandum (32 pages). Also, a staff memorandum (20 pages) presents a summary of interviews of several individuals prominent in the accounting, legal, financial, and investment communities, which were conducted by a Commission staff member in Los Angeles and San Francisco, California, in March 1975.

Roundtable Discussion on Auditor's Responsibilities and Capital Markets

The Commission and the Ross Institute of New York University, with financial assistance from Haskins & Sells and the AICPA, jointly sponsored a one-day symposium on Auditors' Responsibilities and Capital Markets at the Ross Institute on May 11, 1976. Several individuals from various disciplines joined members and senior staff of the Commission in a roundtable discussion of the influence of theories about capital markets on the role and responsibilities of independent auditors. Cochairmen were Douglas R. Carmichael of the AICPA and Michael Schiff of the Ross Institute. Discussion leaders were Robert S. Kaplan, Carnegie Mellon University, on "Implications of the Efficient Market Theory for Independent Audits"; George Benston, the University of Rochester, on possible contributions of in-

dependent auditors to the efficiency of capital markets; Martin Gruber, New York University, on "Implications of Portfolio Management Models for Independent Audits"; and Robert K. Elliot, Peat, Marwick, Mitchell & Co., on "The Cost-Benefit Aspects of the Audit Function." Reference material consists of an edited transcript of the discussions (228 pages) with outlines for the discussions prepared by the four discussion leaders and a list of participants.

Securities and Exchange Commission

On February 6, 1975, members and staff of the Commission discussed the scope and organization of the study of auditors' responsibilities at a one-day conference with the commissioners and senior staff of the Securities and Exchange Commission. The conference consisted of a brief session with the SEC commissioners, a morning session with the chief accountant and senior staff members of the enforcement division, and an afternoon session with the chief accountant and senior staff members of the corporate finance division. A staff memorandum (11 pages) summarizes the views expressed. Also, on August 6, 1976, some members and some of the senior staff of the Commission discussed problems encountered in SEC enforcement proceedings against auditors at a conference with staff members of the SEC in Washington, D.C. A staff memorandum (25 pages) and a two-page agenda summarize the matters discussed.

STAFF ANALYSES OF CASES INVOLVING ALLEGED AUDIT FAILURES

Description of Study

As part of its consideration of the underlying causes of substandard performance, the staff of the Commission catalogued and analyzed major civil, criminal, and SEC enforcement cases involving alleged audit failures.

This is a brief description of the project. The results are summarized in section 9 of this report. In using the analysis of cases as a partial basis for conclusions on the causes of substandard audit performance, the members of the Commission used the detailed reports, which were prepared by the staff on each major case, and other supporting materials. These reports and the principal sources used by the staff are listed at the end of this summary and are available for inspection in the AICPA library.

The following means were used to determine cases for analysis. The Commerce Clearing House *Securities Law Reporter* was reviewed for decisions rendered since 1966. Accounting Series Releases were reviewed to identify significant proceedings. Legal counsel of several accounting firms were asked to suggest additional cases. Certain well-known legal cases, such as *National Student Marketing, Herzfeld, Yale Express,* and *Hochfelder* were selected for initial review. The staff selected other cases based on its judgment as to whether they applied to the Commission's work and whether a meaningful public record on the particular matters involved was available.

For civil and criminal actions brought in the U.S. District Court for the Southern District of New York, the staff obtained access to depositions, motions by plaintiffs and defendants and their respective replies, trial transcripts, and the judge's opinion. When such documentation was not available, the staff's analysis was based on published Accounting Series Releases, written opinions in court cases, articles in books, professional journals, and newspapers, and review of the allegedly deficient financial statements.

The analysis was not intended to determine whether the judge or jury or the SEC came to the "right" conclusion. Nor was the staff concerned with determining the culpability of the auditors involved beyond identifying the existence of substandard performance. The purpose of the analyses was to identify those factors that contributed to the auditor becoming involved in the litigation or regulatory enforcement action. In some cases, the staff concluded that the auditors involved had performed adequately and that

substandard performance was not an issue for investigation. However, many of the cases analyzed involved some failure of auditor performance, which is generally referred to in this paper as "substandard performance." In such cases, the staff attempted to identify the reasons for the failure to detect or disclose or otherwise correct the alleged deficiencies in the financial statements.

List of Cases

The following is a list of the cases analyzed and the materials used in the analyses. The detailed analyses and the supporting material are available for inspection in the AICPA library.

Case	Resources
Fischer v. *Keltz* (Yale Express)	Report on inspection by David Berdon & Co. of PMM & Co. files relating to special work in 1964 and to the examination of financial statements for the years ended December 31, 1962, 1963, and 1964 of Yale Express System, Inc., and subsidiaries. U.S. District Court Decision, 266 F.Supp. 180 (S.D.N.Y. 1967) Various motions and responses of both plaintiff and defendant filed with the district court. Articles, *Journal of Accountancy* and *Fortune.*
McLean v. *Alexander* (Technidyne)	[current] CCH Fed. Sec. L. Reptr., par. 95,725 (D. Del. 1976)
Stirling Homex	*In The Matter of Peat, Marwick, Mitchell & Co.,* ASR No. 173 (July 2, 1975) Various articles, *Journal of Accountancy, Fortune,* etc.
Equity Funding	*In re Seidman & Seidman,* ASR No. 196 (Sept. 1, 1976) Report of the Trustee of Equity Funding Corporation of America Deposition of Wm. C. Suttle, Proceedings, U.S. District Court, Central District of California Transcript, *U.S.* v. *Julian S. H. Weiner,* U.S. District Court, Central District of California Various articles, *Wall Street Journal, The CPA,* etc.
Neidermayer v. *Neidermayer*	[1973 Transfer Binder] CCH Fed. Sec. L. Reptr., par. 95,725 (D. Ore. 1973)
Lewis v. *Marine Midland*	Referee's analysis and report Complaints, original and amended, U.S. District Court, Southern District of N.Y. Various memorandums filed by plaintiffs and defendants in the U.S. District Court of the Southern District of New York, 68 Civ. 1764 (Palmieri)
Herzfeld v. *Laventhol, Krekstein, Horwath & Horwath*	U.S. District Court Decision [1973-74 Transfer Binder] CCH Fed. Sec. L. Reptr., par. 94,574 (S.D.N.Y. 1974) Testimony and documentation U.S. Court of Appeals Decision, [current] CCH Fed. Sec. L. Reptr., par. 95,660 (2d Cir. 1976) U.S. Court of Appeals, appellant and appellee briefs

Case	Resources
Westec	Articles in *Wall Street Journal, New York Times, Journal of Accountancy*
National Student Marketing	*In the Matter of Peat, Marwick, Mitchell & Co.,* ASR No. 173 (July 2, 1975) Transcript of *U.S.* v. *Natelli et al.* U.S. Circuit Court of Appeals [1975-76 Transfer Binder], CCH Fed. Sec. L. Reptr., par. 95,250 (2d. Cir. 1975) U.S. Court of Appeals, appellant and appellee briefs Supreme Court of the U.S., appellant and appellee briefs
Escott v. *BarChris Construction Corp.*	U.S. District Court Decision, 283 F. Supp. 643 (S.D.N.Y. 1968) Memorandum of plaintiffs to trial court Post-trial memorandum of defendant and plaintiffs' brief in reply to defendant's assertions Various articles
Hochfelder v. *Ernst & Ernst*	U.S. District Court Decision, 350 F. Supp. 1122 (N.D. Ill. 1974) U.S. Court of Appeals Decision, 503 F.2d 100 (7th Cir. 1974) Supreme Court Decision [1975-76 Transfer Binder] CCH Fed. Sec. L. Reptr., par. 95,479 (U.S. Sup. Ct. 1976) *Hochfelder* v. *Midwest Stock Exchange,* 503 F.2d 364 (7th Cir.) Cert. denied, 419 U.S. 875 (1974) *SEC* v. *First Securities Co.,* 436 F.2d 981 (7th Cir. 1972), Cert. denied, 409 U.S. 880 (1973) U.S. District Court, complaints and answers to complaints U.S. Court of Appeals, appellant and appellee briefs, and appellant reply briefs U.S. Court of Appeals, appellant and appellee appendix
U.S. Financial	*Touche Ross & Co.,* ASR No. 153 (Feb. 25, 1974) Various articles
Rhode Island Hospital Trust National Bank v. *Swartz, Bresenoff Yavner & Jacobs et al.*	U.S. Court of Appeals Decision, 455 F.2d 847 (4th Cir. 1972) U.S. Court of Appeals, transcript U.S. Court of Appeals, appellant and appellee briefs
Grimm v. *Whitney Fidalgo Seafoods, Inc.*	Prospectus, August 1971 Complaint and Motion for Dismissal, U.S. District Court for the Southern District of New York, 73 Cir. 1304 (Brient)
Koch Industries, Inc. v. *Vosco*	[1972-73 Transfer Binder] CCH Fed. Sec. L. Reptr., par. 93,705 (D. Kan. 1972)
Browning Debenture Holders' Committee v. *DASA Corporation*	Complaint and Motion for Dismissal, U.S. District Court, Southern District of New York [1974-75 Transfer Binder] CCH Fed. Sec. L. Reptr., par. 94,727
Independent Investors Protective League v. *Avco Corporation*	Complaint and Motion for Dismissal, U.S. District Court, Southern District of New York [1974-75 Transfer Binder] CCH Fed. Sec. L. Reptr., par. 94,943 (S.D.N.Y. 1975)

Audit Partners and Staff

During 1976 Professor John Grant Rhode of the University of California at Berkeley conducted for the Commission a questionnaire survey of CPAs to ascertain the influence of selected aspects of auditors' work environment on professional performance of CPAs. The survey sample was selected from the membership roster of the AICPA. It was drawn to represent a population of auditors from national, regional, and local CPA firms with a composition of approximately 75 percent currently engaged in public accounting and 25 percent who had left public accounting after at least two years of auditing experience. Because the AICPA roster does not indicate position or rank within CPA firms and because the survey was designed to have 50 percent of the respondents from senior and staff levels, two separate samples were drawn. The first sample was a random selection from the entire AICPA membership, and the second, which was expected to have a large concentration of senior and staff accountants, was drawn from those individuals who became AICPA members within the last two years. A letter explaining the survey and requesting participation and a reply postcard were mailed to subjects in the first sample during the last week of February 1976 and to subjects in the second sample during the first week of May 1976. A primary consideration in determining eligibility for participation was that all persons selected should have two years of auditing experience with a CPA firm. A 91-item questionnaire was mailed to those who met the survey criteria and expressed a willingness to participate.

The critical questions investigated whether certain aspects of an auditor's work environment, such as pressures from time budgets and concerns over job survival or advancement within the firm, affect the professional integrity and objectivity of auditors to an extent that challenges or compromises the independence of CPAs or impairs the quality of professional performance in other ways. The areas covered in the survey and the number of questions devoted to each area were demographics, 6; quality of education, 5; understanding of auditors' responsibilities, 25; impact of time and budget pressures on quality of performance, 5; substandard performance, 14; adequacy of the scope of audits, 13; disclosure in financial statements, 7; quality control and personnel policies, 8; and non-auditing services, 8. An analysis of the responses indicates that the results are statistically valid and are not weighted toward class titles or toward present or former auditors.

This summary presents for the convenience of readers of the Commission's report only some of the highlights from the analysis of the data from the survey. (Question numbers are included to facilitate reference.) Professor Rhode has prepared a detailed report containing an extensive analysis of the data, the tabulated responses to the objective questions, with cross-tabulations and statistical analysis according to type of firm, staff levels of respondents, and years of experience of the respondents, tabular presentations that categorize and present statistical analyses of responses to open-ended questions, and listing of selected responses to open-ended questions. The report (John Grant Rhode, *Survey on the Influence of Selected Aspects of the Auditors' Work Environment on Professional Performance of Certified Public Accountants,* February 24, 1977, 353 pp.) is available for study in the AICPA library.

Demographic Characteristics. Of 4,888 CPAs screened in the original sample, 2,770 responded and expressed a willingness to participate in the survey, of which 2,016 who met the criteria for participation were mailed questionnaires. The response rate among those receiving questionnaires was 41 percent. The responses to the survey were tabulated and cross-tabulated in a number of ways, including type of firm (national, regional, local), posi-

tion in the firm, and years of audit experience. The composition of the original sample and of the responses to the questionnaire was as follows:[1]

	In Public Accounting		Out of Public Accounting		Total	
Originally random sampled:	3,481		1,407		4,888	
Percent	71		29		100	
Response to survey:	1,064		386		1,450	
Percent	73		27		100	
Responses by firm size:	No.	Percent	No.	Percent	No.	Percent
Local	440	41	47	12	487	34
Regional	61	6	17	5	78	5
National	563	53	322	83	885	61
	1,064	100	386	100	1,450	100
Responses by staff classification:	No.	Percent	No.	Percent	No.	Percent
Staff accountant	72	6	38	10	110	8
Senior accountant	550	52	224	58	774	53
Manager	265	25	107	28	372	26
Partner	117	17	15	4	192	13
No response			2		2	
	1,064	100	386	100	1,450	100

Education of Auditors. Although 90 percent of all respondents majored or concentrated in accounting for their last degree (Q2), there was general dissatisfaction on all levels with the college training preparing them to do auditing. Of those in practice 44 percent, and of those who have left the profession 40 percent, indicated that their college training did not prepare them for their role as auditors (Q4).

Although some respondents graduated from college 20 to 30 years ago, there was an overwhelming belief that their education was inadequate because it did not relate the theory of auditing to practical implementation. A significant number of responses to subjective questions suggested that the best way to alleviate that gap in college training was to provide students with meaningful experience, such as internship programs, or to use more case analysis at the college level. Some typical causes of the discontinuity between theory and practice identified in subjective responses (Q5) were

> No understanding of the mechanics of how an accounting system operates and what the related documentation looks like.
>
> University training taught enough of why to audit, but not how to.
>
> Inadequate emphasis of communication skills and human relations.

Another frequent comment was that college accounting programs, "didn't provide enough auditing credits." Most respondents felt that one or two courses in auditing were disproportionate to the skills they needed when they entered the profession.

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1. This summary is based on 1,450 responses. Final tabulations, not available at the time of publication, will include some additional responses. The Commission has no reason to believe that the final results will differ materially from those presented here.

A summarization of the reasons why respondents believed their education was insufficient follows.

Deficiency in Education	Number of Times Responses Indicate Problem
Poor integration of audit course with practical side of auditing	404
Not enough time spent on auditing	60
Incompetent professors and textbooks which did not relate to public accounting	51
Not enough theory, reason, and logic of auditing	40
Inadequate emphasis of authoritative literature	24
Not enough accounting	24
Other infrequent responses	64
	667

When asked, "Are the training opportunities provided by your firm helpful to you in your audit work?", 1,325 of the respondents (91 percent) indicated they were (Q6). Of those who believed that such programs were not, 125 (9 percent) indicated that a formal firm training program did not exist or, if it did, it was very limited. Several respondents also replied that the training function was being administered on the job, but because of time constraints, the supervision necessary to accomplish this function was inadequate (Q7).

Although an understanding of the client's business was rated as important, 29 percent and 41 percent, respectively, of those in and out of the profession indicated that their firm did not provide them with written or verbal information about the client's organization, industry, or method of doing business (Q14). Of those in the profession who felt such information was inadequate, 31 percent were partners or managers representing 22 percent of those partners and managers responding to the survey. Dissatisfaction with the information concerning the client's business was more prevalent at lower staff levels and at local firms.

Evidence in the Commission's analysis of legal cases involving auditors indicated that deficiencies in technical, particularly industry, expertise have not been completely eliminated by firm training programs.

Auditors' Understanding of Their Responsibilities. Grouped in this category are questions dealing with the respondents' perceptions of their responsibilities to third parties and to their employer firms and perceptions of factors which lead to success in public accounting. This category also includes questions regarding independence.

Most respondents believe that their primary responsibility is to the investing public. They do not believe that bowing to client pressure is beneficial to success. However, meeting time deadlines, including budget deadlines, is believed to be important in determining advancement within a firm. The ability to meet time budgets and the willingness to work overtime to meet deadlines were considered more important to advancement by those no longer in practice (Q12, 13).

Respondents indicate that time budgets are approved at manager and partner levels (Q17), but responses *imply that* negotiated fees influence the scope of the audit. When asked, "Are the audit program and time budget ever influenced by client negotiated fees?" (Q16), 842 of the respondents (58 percent) replied that they were.

Favorable professional perceptions of responsibilities by auditors are supported by the low incidence of failure to make audit adjustments because of the adverse effect they may have on clients' financial success. Only 52 respondents (4 percent) said that they did not adjust a client's financial statements because of the adverse effect the adjustment or disclosure would have had on the financial success of a client (Q63).

When asked if their relationship with clients ever caused the respondents to question

their personal independence, only 10 percent of those in or out of practice indicated it had (Q65). However, 24 percent and 30 percent, respectively, of those in and out of the profession believed that their firm's relationship with a client impaired their firm's independence (Q66). Of those in the profession who believed their firm was not independent, approximately 16 percent were from national firms but 32 percent were local firm respondents. The cause most frequently given for auditors' lack of independence was the significance of the audit fee to a firm or office or, similarly, the fear of losing a large client (Q67). Only 7 respondents indicated that independence was impaired by their firm's performing nonaudit services. Other suggested causes for the lack of independence were personal financial interests in clients, acceptance of gifts, and family relationships with clients (Q67).

In answer to a question requiring the respondents to rate how great the "present arrangement whereby the client pays auditors' fees adversely affects an auditor's ability to resist pressure to subordinate his or her judgment?" (Q68), 64 percent in and 51 percent out of the profession rated the relationship not greatly adverse or not adverse at all. Those who thought the relationship was adverse suggested solutions such as the establishment of audit committees to set and negotiate fees, standardization of audit fees by regulation, mandatory rotation of auditors, payment of fees from a pool funded by clients, and disclosure of reasons for auditor changes (Q69).

Of the total respondents 1,098 (76 percent) believed that "accepting gifts from audit clients, other than infrequent meals or gifts with a value of less than $25, affects an auditor's ability to resist pressures to subordinate professional judgment" (Q84). Of the total respondents, 90 (6 percent) once accepted a gift with a value over $25 from an audit client (Q78). However, when asked the approximate *cumulative* value of gifts accepted from all audit clients (Q85), responses were as follows.

	Responses	
	Number	*Percent*
$25 or larger, but less than $100	348	24
$100 or larger, but less than $1,000	128	9
$1,000 or larger, but less than $5,000	8	–
$5,000 or larger	–	–
Not applicable	966	67
	1,450	100

Of the respondents in public accounting, 361 (34 percent) indicated that their firms had no policy prohibiting auditors from accepting gifts from clients (Q87). Of such responses, 252 were from local firms.

Respondents also indicated that "purchase of audit client products at a discount not available to the public affects an auditor's ability to resist pressure to subordinate his or her judgment" (Q91). Of the total respondents, 521 (36 percent) had done so (Q88), and 961 (66 percent) indicated that their firm had no policy to prohibit such actions (Q90).

Nonperformance of Audit Work and Time Pressures. Anecdotal evidence presented to the Commission suggested the possibility that auditors may, with some frequency, indicate on audit programs that they had performed work, when in fact the work was not performed. Accordingly, several questions were designed to elicit information on the prevalence of this practice.

When asked, "During the course of an audit, have you ever signed off a required audit step, not covered by another audit step, without completing the work or noting the omission of procedures?" (Q28), 58 percent of those in the profession and 61 percent of those out of the profession answered Yes. Of those in practice 31 percent, and of those not in practice 47 percent, believe "pressure to meet the time budget motivates individuals

to sign off required audit steps not covered by another audit step without completing the work or noting the omission of procedure" (Q20). Of those in the profession 23 percent, and of those out of the profession 31 percent, answered Yes when asked, "Have you ever signed off a required audit step not covered by another audit step . . . because of pressure to meet the audit time budget?" (Q33) Twelve percent of those in, and 14 percent of those out, of the profession indicated that they signed off required audit procedures without performing the step because of client imposed deadlines (Q34).

Approximately 47 percent of all respondents, or 80 percent of the respondents who said they had failed to perform a required audit procedure, indicated it was infrequent (less than 10 times) and that they were satisfied with the extent of the examination (Q28).

When asked to rank several situations where auditors may be likely to sign off required audit steps not covered by another audit step (Q24), situations cited most frequently were these:

In any area of the audit because of personal judgment that the audit procedure is unnecessary.

In areas where standard sources of information have proved reliable to substantiate client records during prior years' audits.

In areas where little working paper documentation will be compiled.

A majority of respondents indicated that the point in an individual's career when he or she is most susceptible to signing off required audit steps not covered by another audit step, without completing the work or noting the omission of the procedure, is at the staff accountant level or below (Q23). Respondents ranked "risk of discovery by their supervisor" as the greatest concern of those "individuals who sign off an audit step without being satisfied with their examination" (Q25). When asked to "indicate the disposition" of the discovery when "the omission of required work was discovered" (Q30), the responses were as follows.

	Number of Responses
Procedure performed, and individual reprimanded and/or "fired"	394
Procedure performed	291
Reasons for omission justified	214
Omission "never discovered"	208
	1,107

Subjective responses indicated that a primary cause of substandard audit performance such as that noted above is a very high level of time pressure.

Responses to the question, "What is the primary motivating factor for individuals to sign off required audit steps not covered by another audit step without completing the work or noting the omission of procedures?" (Q35), are summarized as follows.

	Number of Responses
Time budget pressure	533
Step considered immaterial, audit program improperly tailored including insignificant steps	329
Misunderstood auditing procedure due to inexperience or poor supervision	200
Client or regulatory reporting deadline	120
Laziness, boredom, and disdain for detailed audit work	119
Speed is the most important standard to measure auditor ability	80

(Continued)

	Number of Responses
Inadequate technical ability to perform step in allotted time	19
Lack of integrity	15
	1,441

Responses to the question, "What do you consider to be the primary cause for substandard audit performance by audit personnel?" (Q60), are summarized as follows.

	Number of Responses
Lack of experience, knowledge, and training	788
Time pressure (unspecified) or time-budget pressure	474
Improper review and supervision	456
Carelessness or boredom of repetitive assignments	192
	1,910

The following are typical detailed responses to these subjective questions:

Pressure to get the job done and receive a good performance evaluation.

Professionalism has been completely thrown out in favor of the business aspects (time budgets and fees) in the practice of public accounting.

Client retention considerations force low fees and time budgets and a willingness to compromise with clients in troublesome areas.

Lack of fee, lack of time, lack of supervision.

Time pressure resulting from an inadequate time budget. Budgets are too little but the partners want you to finish the job within the budget.

The cost factor involved. "Time is money."

Time pressure including overtime pressure during peak busy season when everyone has too much to do. Insufficient training after college in keeping up to date and progressing above staff level.

Overcommitment of time results in time pressure, failure to keep current technically, and a third-rate examination and report (opinion).

Time budgets—Steps are completed but at times there could be more work done—budgets (deadlines) would not permit it so the minimum amount of work is done.

To begin with, staffmen seem to know less and less when graduating from college. Used to be, a new man at least knew the difference between a positive and negative confirmation and knew how to prepare a bank reconciliation and proof of cash. Now, they have to be spoonfed the entire job and they fail to respond to a request to follow a budget. After having to cut our fees on the first couple of jobs, the juniors panic, and even though they still don't have enough experience to make necessary decisions, they short cut on work to start "looking better" come time to bill the job.

Management is primarily concerned with billing. The pressure, if not direct, can create an atmosphere of "just getting the field work done and the report out the door." There is absolutely no reward for creativity if it measures the time, and a new approach is questioned if it doesn't do everything which was done before (even if that were bad) and more.

Time constraints which individuals feel that they have to adhere to.

Competition among auditors within a firm who feel success comes from meeting time budgets.

Time pressures. Whenever the time charges are not fully billable (due to: (1) Competitive pressure; (2) Client pressure to lower the audit cost; or, (3) Fixed fee audits) there is intense and unrelenting pressure to somehow complete all required work in substantially less time than in the prior year. Nobody ever asks how you succeeded in such situations.

In response to objective questions, 25 percent of those in the profession and 40 percent of those who have left the profession believe that "pressures to meet client imposed deadlines motivate individuals to sign off required audit steps, not covered by another audit step, without completing the work or noting the omission of the procedure" (Q21). In addition 514 (48 percent) of those in the profession and 222 (59 percent) of those not in public practice believe that pressures to minimize the number of audit hours have increased over the past three years (Q18). Among those in the profession who believe pressures have increased were 315 national firm members and 223 partners or managers. Further, when asked, "What effect does the need to meet the audit time budget have on the professional performance of auditors?" (Q22), 48 percent (in) and 58 percent (out) responded that it had a negative effect. Of those responding that the need to meet time budgets have a negative effect on performance, 144 (33 percent) are partners or managers in practice.

More than one-half (55 percent) of the respondents indicate that they react to audit time pressures by completing required procedures on their own time without reporting the hours (Q19).

The responses to objective questions dealing with substandard audit performance and the frequency of respondents alluding to time-budget pressure in many subjective responses, suggest that this is a significant cause of substandard audit performance. Such an impression supports conclusions reached in the analyses of cases involving alleged audit failures.

The Adequacy of the Scope of the Audit. Approximately 57 percent of the respondents have "experienced situations where the scope or extent of the audit work done in any area of the engagement was not adequate" (Q37), and their "concern over the inadequate audit work" was not resolved to their satisfaction (Q38). These scope inadequacies rarely related to suspected irregularities in a client's financial records (Q42). Incidence of scope reductions based on clients' requests when respondents believed the request unwarranted occurred in only 1 percent of the responses (Q54).

Based on subjective responses, many of the alleged scope inadequacies were justified at the time of the audit by respondents' supervisors. However, the respondents believed that the judgment exercised by the superior was incorrect. Other explanations for inadequate scope were time budgets and inflexible fees, and poor planning in conjunction with improperly tailored audit programs (Q39). Areas of the audit where scope was believed inadequate were generally inventories and accounts payable. In a question asking participants if they were "aware of any situations where a report qualification due to a scope limitation was required" but not issued (Q58), only 77 respondents (5 percent) replied affirmatively. Relating this response to the response that the scope of an audit was inadequate implies that the scope limitations were either not in significant audit areas or the respondents did not consider the inadequacy so important as to require an exception in the report. A few respondents believed that the reason why auditors fail to properly report scope limitations was that partners sometimes compromise judgment because of client pressure (Q59).

Quality Control. Responses indicated that most firms have appeal processes for disagreements involving the scope of the audit, irregularities in clients' financial statements, accounting presentation, and financial statement disclosure, and that the process is used (Q49). Although most of the respondents believe that their appeal will receive fair and objective consideration, generally there appears to be some hesitancy to use the appeal process because of its possible adverse effect on advancement (Q52, Q53). The appeal process in approximately 72 percent of respondents' firms is informal (Q51).

Nonaudit Services. Of the total respondents, 126 (9 percent) indicated they had experienced situations where they were pressured by their firm to promote unnecessary consulting services to audit clients (Q70). A few, 88 individuals (6 percent), indicated that they had experienced resistance from supervisory audit personnel or "felt reluctant to identify internal control weaknesses in a system adopted by the client as a result of consulting services provided" by their firm (Q72). In addition, 61 respondents (4 percent) felt there was "pressure from supervisors to accept the representations by former members of (their) CPA firm now employed by the client or from those individuals placed with a client following an executive search by (their) firm" (Q75).

In summary, there is little evidence in the survey that nonaudit service impairs independence. Only a few respondents, 90 (6 percent), felt that consulting work performed by CPA firms affects independence of auditors by contributing to substandard audit performance (Q76).

The Auditor's Standard Report

A questionnaire survey of the attitudes toward the auditor's standard report of three groups of users (bankers, financial analysts, and individual shareholders) was conducted during 1976 by Professor Richard E. Ziegler of the University of Illinois. The survey focused on identifying users' perceptions of the responsibility assumed by the auditor; the degree of assurance that users obtain from the report; and users' interpretations of three technical terms: "generally accepted accounting principles," "present fairly . . . in conformity with generally accepted accounting principles," and "examination . . . in accordance with generally accepted auditing standards." A questionnaire was mailed under the letterheads of the Robert Morris Associates and the Financial Analysts Federation to serially selected samples of their respective memberships. A similar questionnaire was mailed under the letterhead of the AICPA to individual shareholders serially selected from a listing of purchasers, within the preceding year, of at least one round lot of shares listed on either the New York or American Stock Exchanges. The size of the samples and the number of responses were as follows.

	Bankers	*Financial Analysts*	*Individual Shareholders*
Number surveyed	400	298	1,851
Number of responses	214	118	188
Response rate	54%	40%	10%

The survey showed that most of the respondents read or scanned the auditor's report and believed they had a reasonable understanding of it and that most of those that did not read it completely were familiar with it and only look for departures from the standard form. Most indicated that familiarity with the name of the auditing firm affected the credibility of the financial statements. Roughly equal percentages viewed the responsibility

for the selection of accounting principles as being solely or primarily management's, solely or primarily the auditor's, and shared equally by management and the auditor.

Respondents believed the auditor's report provided them with moderate to high levels of assurance about a wide range of matters, including the adequacy of the accounting system to produce proper financial statements; the adequacy of the internal control system; the compliance with the internal accounting and control systems; and the detection of fraud, conflict of interests, or other irregularities.

Respondents by varying majorities agreed that GAAP are "composed, in part, of customs and conventions that are generally recognized as authoritative by accountants"; "consistent in requiring that principles, once adopted, be applied on a consistent basis from period to period"; "specific in requiring that the same principle be used for all similar transactions or events within the company"; "a sufficient basis for preparation of financial statements that will be reliable for use in decision making"; "different for different industries"; "general enough to be applied in a number of equally acceptable ways in some circumstances"; "almost entirely composed of a set of written pronouncements recognized as authoritative by accountants"; "intended to provide reliable measurement of the underlying earning power of the company"; and "intended to assure reality in financial statements." Similar majorities agreed that "present fairly . . . in conformity with GAAP" states nothing more than that the financial statements are in conformity with accounting principles that have general acceptance; implies that the financial statements would not differ in any significant way if a different auditing firm had examined them, show the financial soundness of the company, and would not lead to a conclusion that the auditor knows would be unwarranted or incorrect; and asserts that a true financial picture of the company has been presented. They also agreed that an examination made in accordance with GAAS means that the auditor conforms to GAAS; evaluates the adequacy of the accounting system; uses procedures specifically intended to detect fraud or other irregularities; relies almost entirely on GAAS in determining detailed procedures; has unlimited access to the client's personnel and supporting materials; and would not be satisfied until convinced beyond any doubt that the financial statements are not misleading.

Claims in Litigation

Several major CPA firms cooperated in a project to compile and analyze for the Commission aggregated data on causes of claims in litigation. Legal counsels of the participating firms coordinated the project. Each participating firm compiled information on a survey form for individual cases and submitted the forms to an organization for compilation and analysis. The Commission received the results of the analysis of the aggregated data.

Opinions on Questionable Corporate Activity

Professor Lewis Davidson of the University of North Carolina coordinated for the Commission a questionnaire survey of analysts and investors to ascertain opinions on reporting on questionable corporate activities. The survey was conducted during 1976. Questionnaires were mailed under the letterhead of the Financial Analysts Federation to a selected sample of its members. Similar questionnaires were mailed under the letterhead of the AICPA to individual shareholders selected from a listing of purchasers, within the preceding year, of at least one round lot of shares listed on either the New York or American Stock Exchanges. The questionnaires were designed to obtain opinions of analysts and shareholders on the desirability of the disclosure of information concerning illegal political contributions, bribes, and payments to foreign agents, and other questionable corporate activity. The analysis of the data from this survey was not completed by the

date of publication of the Commission's report but will be available for inspection in the AICPA library upon completion.

Resolution of Uncertainties Disclosed in Annual Reports

This project was planned to be a study of the effectiveness of the reporting of uncertainties by comparing the resolution of uncertainties with previous financial statement disclosures. Personnel of Touche Ross & Co. undertook the preliminary planning and exploration for the project. They presented a research design and an assessment of the project at the August 1976 meeting of the Commission. The survey was designed to answer questions such as, Was the outcome of material uncertainties more adverse when accompanied by an auditor's report with a "subject to" qualification? Of the total number of uncertainties included in the survey, what was the average duration between origination and resolution? What is the demography of uncertainties resolved? Did auditors' reports change relative to changes in the status of uncertainties? What level of materiality and prediction relates to the nature of the auditor's report rendered?

The assessment of the project was that it was doubtful whether reliable conclusions could be developed from the empirical data resulting from the kind of manipulation proposed; although the phenomena can be observed, unmeasured or unmeasurable factors would most likely have a significant influence on the results.