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Report to Council of the American Institute of Certified Public Accountants, Denver, Colorado, September 30, 1972

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A Report to Council
of the
American Institute of Certified Public Accountants
Denver, Colorado
September 30, 1972
By
Thomas L. Holton
Chairman, Committee on Auditing Procedure

INTRODUCTION

Within the last month, each of you received a copy of the blue brochure entitled "The Accounting Profession - A time of Great Events" prepared by the Institute. That booklet stated that I have served as Chairman of the Committee on Auditing Procedure for three years "during the period when a greater number of Statements on Auditing Procedure were issued than at any other time in the 30 year history of these committees". With that kind of advance billing, what I would like to do today is tell you about all of the great events resulting from the Committee's work under my chairmanship. Although I would like to do that, I will forego that pleasure. Instead, I will talk mostly about things that we haven't done, some of which I fully expected the Committee to have accomplished by now. In doing so, I suppose one might characterize this report as being mostly suggestions to the new Chairman, Ernie Hicks.

1969 PREDICTIONS

As indicated, I am not going to dwell much on history. In preparing to make this swan song to Council, however, it occurred to me that some perspective might be added by reviewing the predictions I made in my 1969 speech at the annual meeting in Los Angeles. I had just been appointed Chairman of the Committee and, as might be expected, I stuck my neck way out by making some predictions of things to come. For example, I had this to say:

"Recognizing the complexity of current problems and their multitude, some of the officers and members of Council of the Institute have been pressing rather hard recently to increase the production of the Committee. I think this will come to pass. I hasten to add, however, that I strongly believe it is better to do nothing (or not issue a Statement, at least) than to publish something that

will not stand the test of time. In other words, we must be sure we are right, rather than getting out Statements just for the sake of production."

Of course, actual results are never the same as forecasted, but I think it is fair to say the Committee's actual performance during the last three years was at least somewhat in keeping with my prediction about production. However, the problems resolved by issuance of Statements on Auditing Procedure have been quite different from those that I predicted would be resolved. In that 1969 speech, I mentioned 20 topics that were either under consideration by the Committee or that I thought should be under active consideration, 14 of which I predicted would result in Statements on Auditing Procedure before the end of 1972. The Committee has pronounced on only 7 of the 14 that I predicted. I would have liked for the Committee to do better, but this was not entirely unexpected, as indicated by another part of my 1969 speech:

"The topics enumerated and my suggested target dates merely indicate my present thinking about plans for the Committee. As you know, even the best laid plans often go astray. I am sure some projects will be delayed, but hopefully, others will be accelerated at the same time and, of course, there are always those first to be put out. Let's hope the real emergencies are few." "Being realistic, and recognizing that we don't operate in a vacuum, I am sure the Committee will not get completely away from reacting to critical situations as they arise. This was the case in the beginning of the Committee with the McKesson-Robbins fiasco and in more recent times with the problems arising out of Continental Vending, Bar Chris and the salad oil scandal, etc. More importantly, however, I hope we can do more fire prevention work, as contrasted to fire fighting."

You are familiar with the Statements that have been issued, so I will not enumerate those. You may be interested in knowing, however, about what happened to those 7 projects that I predicted would result in Statements, but which did not. Those were:

1. Clarification of a whole area of negative assurance - In view of other pressing matters, this project just was not high enough on the priority list. I still think it deserves the attention of the Committee because the profession is in need of guidance in this area.
2. Reporting on price level financial statements - We have had more than one draft of an SAP on this subject, but it was dropped from active consideration because so few companies in this country are publishing price level information. If it should become an important topic in the future, another committee will have the benefit of the groundwork that has already been done.
3. Revision of Short-Form Report - When I became Chairman of the Committee, I planned to push very hard for a revision of the Short-Form Report and the subcommittee has done a great deal of work on this subject. Be that as it may, the full Committee decided during the past year (not unanimously, by any means) to drop this topic from active consideration, principally for the following reasons:
 - a. The changes we could agree upon were not dramatic enough to justify the additional time and effort that would be required to publish a new standard Short-Form Report along with the related rationale and explanatory material that would go into an SAP.

- b. The changes we could agree upon appeared to be negative from a public relations viewpoint. We just didn't think this was the time to be negative public relations.
- c. The developments within the next year or so with the Financial Accounting Standards Board and the Objectives Study Group may have some bearing on this subject.
- d. Other more pressing problems seemed to deserve the Committee's attention.

A new Committee may decide to reconsider this question. I hope so.

- 4. Computer Auditing - This one never emerged as an active agenda item for the senior committee, but some progress has been made by the Auditing and EDP Committee.
- 5. Transactions with affiliates - This is a difficult area in which the profession needs guidance. The subcommittee, as well as the full Committee, has spent considerable time in an effort to issue a pronouncement that would be helpful to practitioners. I think we are getting rather close and hopefully a Statement will be issued next year.
- 6. Philosophy and objectives of auditing - Three years ago, I felt the profession needed more in the official literature regarding the philosophical underpinnings of auditing. My idea was to develop a better framework into which all other auditing pronouncements would fit. Other projects of a more pressing nature have precluded this subject having any active consideration by the Committee. Also, I am not nearly as convinced now that it is really needed.
- 7. Evaluation of competence of audit evidence - This one never emerged as an active agenda item.

STATEMENTS YET TO BE ISSUED BY 1971-72 COMMITTEE

The 1971-72 Committee has four projects near completion. In order to expedite the resulting pronouncements and to avoid the time-consuming process of familiarizing new Committee members, the Board of Directors has authorized the old Committee to continue in effect solely for purpose of completing these projects, or until November 8, (the date of the first meeting of the new Committee), whichever is earlier. I will make a few brief comments about these four proposed SAPs.

Reports on Internal Control of Government Grant Agencies

I suppose I have to admit that the Committee got out SAP 49, "Reporting on Internal Control," rather hurriedly after this portion of the overall internal control project was separated from the other aspects of the project. Hindsight is always better than foresight and we now see that the approach could have been better for reporting on internal control for government agencies administering grant programs in those cases where criteria for evaluating adequacy have been developed and published in audit guides, questionnaires, etc.

Although this year's Committee believes the general philosophy set forth in SAP 49 is appropriate, the Committee plans to issue a brief SAP clarifying and modifying some portions of No. 49. This new SAP will modify the prescribed reporting in order to better accommodate those situations in which government agencies have set forth in audit guides, questionnaires, or other publications the criteria that should be used to review and evaluate the adequacy of a system of internal control for their purposes.

The proposed SAP is in process of exposure to the government agencies, the related AICPA committees and others (but not full exposure) and we expect final balloting on this statement at a special meeting of the old Committee next month.

Reporting on Consistency and Accounting Changes

The provisions of Accounting Principles Board Opinion No. 20, entitled "Accounting Changes," made it necessary for the Committee to reconsider Chapter 8 of Statement on Auditing Procedure No. 33 which deals with the consistency standard of reporting. This seemed to be a rather simple project in the beginning, the original objective being merely to update Chapter 8 in order to accommodate the provisions of APB Opinion No. 20. But the more we delved into the matter, the more it became evident that the official literature on consistency needed a thorough overhaul, so we proceeded to consider all aspects of the consistency standard.

This reconsideration resulted in the exposure in July of a Statement on Auditing Procedure entitled "Reporting on Consistency and Accounting Changes". The Committee considered exposure comments at its meeting last week, made several changes and is now in process of formal balloting on an SAP which will contain the following features, among others:

1. Although the auditor's concurrence with a change in accounting is implicit unless he takes exception to the change in expressing his opinion as to fair presentation of the financial statements in conformity with generally accepted accounting principles, in order to be more informative to the reader, the auditor should make his concurrence explicit by so stating in his report. This is a new interpretation of the consistency standard.
2. Although the Accounting Principles Board has defined accounting changes to include a change resulting from a pooling of interest, this type of retroactive change does not call for the usual consistency exception in the auditor's report.

3. If an accounting change results from the correction of an error, the auditor should give recognition to this change in his report, but it is not necessary for him to concur with the change.
4. If an accounting change is inseparable from a change in estimate, as defined by APB Opinion No. 20, this type of change requires recognition in the independent auditor's opinion as to consistency.
5. Reclassifications ordinarily do not require recognition in the auditor's report.
6. When the auditor is reporting on a series of years, his opinion as to consistency must relate to consistency among the years being reported upon, as well as to the first year prior thereto, if that prior year is being presented, even though not reported on by the auditor. This is a new interpretation of the consistency standard.
7. As for preferability of the new accounting principle when a change in accounting has been made, as required by APB 20, the auditor's responsibility is to be satisfied regarding the reasonableness of management's justification for the change.
8. If a client has not provided reasonable justification that an accounting change is to a preferable method, the auditor should express his exception as to consistency and also as to fair presentation in conformity with generally accepted accounting principles in the year of the change. This exception should be repeated for so long thereafter as the financial statements of the year of change are presented, even though the auditor's opinion may not otherwise cover that particular year.

Study and Evaluation of Internal Control

In addition to the problems of reporting on internal control, the Committee has had under consideration for some time a larger SAP that would redefine internal control and give the profession more guidance about how to comply with the second standard of field work. A draft entitled "The Auditor's Study and Evaluation of Internal Control" was exposed to the profession for comment about two months ago and the exposure period ended on September 27. A special meeting of the old Committee will be held on October 18 and 19 primarily for the purpose of discussing, finalizing and balloting on this proposed SAP, taking into consideration the comments received on exposure.

Although our study and evaluation of internal control is fundamental to all of our auditing, there is considerable difference of opinion about what the official literature should say on this subject. You would be surprised at the heated discussion on this topic.

Codification of Statements on Auditing Procedure

Last winter I appointed a special task force of former Committee members to work on a new Codification of Statements on Auditing Procedure. This group, headed by Bob Holsen, has worked most diligently at their task and the Committee has now balloted on the new codification, subject to some final editorial changes which I reviewed with the task force here in Denver yesterday afternoon.

Beginning with this codification, the Institute plans to have a new looseleaf service that will result in automatically updating the Statements on Auditing Procedure as new ones are issued.

PROJECTS FOR THE 1972-73 COMMITTEE

Although production might appear to have been on the high side recently, the backlog of the Committee continues to be lengthy. I will discuss briefly a few

of the problems of the profession that need to be dealt with by next year's Committee.

Transactions with Affiliates

Chapter 9 of SAP 33, dealing with the adequacy of informative disclosures requires that the financial statements disclose "the existence of affiliated or controlling interests and the nature and volume of transactions with such interests". Accounting literature also deals to some extent with disclosures regarding non arm's-length transactions and balances. Overall, however, guidance to the auditor in the professional literature is rather sparse as to what should be disclosed, as well as what the auditor should be doing to find out about the matters that should be disclosed.

At two or three points over the last three years, I have thought the Committee just about had the right answers and that a Statement covering these matters was imminent. We have never quite made it, though. This is a most difficult subject, but something is sorely needed by practitioners, and I am most hopeful that the Committee will issue a Statement next year.

Degrees of Qualifications

During about the last two years, we have had a very active subcommittee working on a project we call "Degrees of Qualifications". The objective is to issue an SAP that would give more and better guidance to practitioners in distinguishing among the situations that should give rise to the auditor's expression of an unqualified opinion and other types of opinions on financial statements and to illustrate the appropriate language for such opinions in various circumstances. I suppose this problem goes all the way back to Statement No. 1 issued in 1939, which stated that the auditor should not express an opinion on financial statements "when his exceptions are such as to negative the opinion". About ten years

later Statement No. 23 required a specific disclaimer on the Statements taken as a whole, again "when his exceptions are such as to negative the opinion". This was carried forward into SAP 32 and SAP 33 with additional elaboration and some illustrations.

The most crucial question is "How does an auditor decide when his exceptions are such as to negative his opinion?"

SAP 33, Chapter 10 requires an "except for" type of qualified opinion when financial statements are materially at variance from generally accepted accounting principles and further provides that if such variance is "sufficiently material" the auditor should express an adverse opinion. Chapter 10 also provides for a "subject to" qualified opinion in cases where uncertainties may have a material effect upon the financial statements. But if "the amount concerned may be so material that a qualified opinion is inappropriate", the auditor should disclaim an opinion.

Practitioners do a great deal of soul searching, and practice varies considerably, on the question of how material a qualification must be before the auditor must either express an adverse opinion or a disclaimer of opinion. Many auditors feel that size alone is not enough. There should be other criteria such as pervasiveness. The Committee is also inclined in this direction.

Indicated below are a number of questions which need to be resolved:

1. Should disclaimers be used only in the case of scope limitations?
2. Should all qualified opinions use the terminology "except for" instead of maintaining the distinction between "except for" and "subject to"?

3. Should all qualified opinion reports contain three paragraphs so as to dramatically alert the reader to the unusual nature of the report?
4. Should reports that have other than unqualified opinions require some special label to alert the reader to the unusual nature of the report?
5. If comparative financial statements are presented, should the auditor be required to either express or disclaim an opinion on all years presented?
6. Should piecemeal opinions be proscribed in situations where the accountant expresses an adverse opinion on the overall financial statements?

The Committee is getting close to resolution of these questions, as well as some other related ones, and I think we will see a Statement covering these problems next year.

Unaudited Financial Statements

One of the hottest topics being discussed by auditors these days does not even deal with auditing. The hot topic is unaudited financial statements. During the year, I appointed a special task force to study the whole subject of unaudited financial statements, particularly to review SAP 38 in the light of the New York court decision in the 1136 Tenants Corporation case. The objectives of the task force are these:

1. To consider the ramifications of the 1136 Tenants Corporation decision and its effect on the accounting profession.
2. To consider the best method of informing the profession of the significance of this case.
3. To determine whether practitioners require additional guidance in preparing unaudited financial statements.

4. To determine whether the current literature needs clarification.
5. To prepare the material determined necessary to assist the profession in this whole area.

The task force has had several meetings and a progress report to the Committee last week indicates that they may well conclude that our present literature is basically sound, although practitioners may need additional guidance in applying the literature in day-to-day practice.

The December issue of the Journal of Accountancy is to be devoted entirely to unaudited financial statement problems. Various articles on the subject will be published and it will include a progress report by the task force. Reactions to this issue of the Journal from members of the profession may be very helpful in finally deciding whether a new SAP is necessary. If additional guidance by way of an official pronouncement is deemed to be desirable, the following areas might be considered:

1. Engagement letters.
2. Distinction between accounting services and auditing procedures.
3. Distinction between unaudited engagements and engagements involving limited auditing procedures which also lead to disclaimers of opinion.
4. Content of working papers.
5. Normal or minimum inquiries auditors should make with respect to unaudited financial statements with which he is associated.
6. Auditor's course of action in the event he learns of errors in unaudited financial statements after they have been issued. (In other words, should the philosophy of SAP 41 be applied to unaudited financial statements, as well as to audited financial statements? This is suggested by the SEC in the National Student Marketing case.)

7. Discussion of the need for and the extent of written client representations.
8. "Internal use only" financial statements, including examples of those notes to financial statements that are always required and those notes that may be omitted.
9. More elaboration than contained in SAP 38 regarding tax returns and other governmental forms that may be used as financial statements.

Negative Assurance

Negative assurance, or possibly more aptly described as double negative assurance, is a subject that has been on the backlog of the Committee for some time. Statement on Auditing Procedure No. 38, "Unaudited Financial Statements", contains a specific prohibition against the independent CPA including negative assurance in his report on unaudited financial statements. Negative assurance usually consists of something like "Nothing came to our attention which caused us to believe the accompanying financial statements do not present fairly financial position and results of operations in conformity with generally accepted accounting principles". Such language was precluded by Statement No. 38 in order to avoid giving the reader the impression that he had some sort of accountants' opinion, negative though it may be.

Statement No. 38 does approve giving negative assurance to underwriters in so-called cold comfort letters and also states that it is appropriate for the auditor to recite procedures performed for purpose of assisting a client in connection with mergers, buy and sell agreements, and "similar circumstances". Some members of the profession have interpreted this to mean that negative assurance can be given in those merger situations and "similar circumstances".

Others think this is not appropriate and, at least by implication, prohibited by Statement No. 38. It seems rather obvious that with this difference of interpretation in practice, something should be done by the Committee to clarify the situation.

Something is being done. The Committee asked the Advisory Task Force on Comfort Letters to undertake a study of the appropriate extent to which negative assurance should be permitted and to draft a proposed SAP on this subject for consideration by the Committee.

The last time the full Committee discussed this subject I think the consensus was something like this: "The conditions under which negative assurance may be expressed should be broadened while at the same time establishing clear-cut and more restrictive guidelines." We meet ourselves coming back, so to speak. We want to expand our services to clients, but we have a great deal of difficulty justifying this one. The Committee is having a most difficult time arriving at a logical stopping point for negative assurance without just outlawing it entirely, including negative assurance in comfort letters to underwriters. If such assurances are appropriate for underwriters, then why are they not also appropriate for purchasers of debt or equity securities in a private placement when no underwriting is involved? Then, if private placement purchasers are entitled to such assurances, why not the local banker who is about to make a loan to the company? Then, the next logical step is that if the banker is entitled to such assurances, why not the trade creditors, Dun & Bradstreet, or anybody else, including the stockholders who receive quarterly unaudited financial statements?

I think this is indirectly related to another topic which must be considered by the Committee, that being the problems of auditing interim financial statements,

or what I sometimes call continuous auditing or instant certifications. I think within the next five to ten years the public will demand increased credibility in published quarterly financial statements and this will be provided by auditors' opinions thereon. If we let negative assurance proliferate, I am afraid the public may well be misled into thinking such assurances are sufficient and that audits are not necessary. I also believe the same thing would happen with smaller companies, not publicly held, in submitting financial statements to bankers and other credit grantors. If bankers and others were getting negative assurances, without audits, the tendency would be not to require audits. I do not think this would be in the public interest, completely separate and apart from its effect on the accounting profession.

Reporting on Forecasts

There has been a lot of discussion lately, in the press and elsewhere, about the desirability of companies publishing forecasts of financial results. Even the SEC is considering the possibility of either permitting or requiring forecasts in prospectuses, reports on Form 10-K, etc. Some financial forecasts are already being published, although not in SEC filings, and in some cases those forecasts are accompanied by accountants' reports thereon.

The Committee on Auditing Procedure has a very active subcommittee working on resolving the various problems involved when a CPA's name is associated with a financial forecast. This subcommittee includes three representatives of the Management Services Division of the Institute who are not members of the full Committee.

Among the questions to be answered are these:

1. Is it appropriate for a CPA to be associated with forecasts of financial information made available to the general public?

2. Is it appropriate for a CPA to expertise a forecast under Section 11 of the Securities Act of 1933?
3. Must management assume primary responsibility for any financial forecast, or is it appropriate for a CPA, in effect, to prepare a forecast on his own and then give an opinion on it?
4. What responsibility should the CPA have for the assumptions used in making a forecast?
5. How should the adequacy of disclosure standard be applied to forecasts, particularly with regard to disclosure of the assumptions?

In view of the increased public interest in this subject, I think it is almost imperative that the Committee issue a pronouncement within the next year.

Other Topics Under Consideration by the Committee

As I said earlier, the Committee has a large backlog of topics that need active consideration by subcommittees and the full Committee. Without any elaboration, I will just mention a few of these topics:

1. Reliance on non-accounting experts
2. Audit supervision
3. Audit committees
4. Qualitative aspects of inventory taking
5. Auditing fair value
6. Using the work of internal auditors
7. Reporting on condensed financial statements
8. Adequacy of informative disclosures

CONCLUDING REMARKS

In concluding my report, I will not make any summary. Instead I would like to introduce the new Chairman, Ernie Hicks, if he is here, and give Ernie a message from the old Chairman. (Attached hereto is an open letter to Ernie Hicks)

OPEN LETTER TO THE NEW CHAIRMAN

Dear Ernie:

In designating you as Chairman of the Committee on Auditing Procedure, the profession has conferred upon you a distinct honor. But, in addition to the honor, there are few small duties that go with the chairmanship.

As you know, Ernie, your job actually began some three months ago when you first agreed to accept this honor, because you were placed immediately on the mailing list for the Committee's correspondence -- which, as you have learned, is truly enormous. You have also spent a considerable number of hours at Committee meetings and subcommittee meetings in order to be sure that you can proceed promptly to establish priorities, schedule meetings, appoint new subcommittees and a few other things that are important to getting the new Committee's activities off to a running start. You may, in fact, feel that you have already done a lot of work just getting ready to go to work, and with this I agree. But we have a few additional chores for you, Ernie.

As Chairman of the Committee, you are expected to attend meetings of Council of the Institute and in most cases you will be scheduled to speak to Council. You should always be prepared with a good report, Ernie. But at the same time, I warn you to also be prepared not to give the report, at least not in its entirety. If time should turn out to be short, as has happened to me on more than one occasion, think philosophically about the whole situation and console yourself with the knowledge that squirming Council members are most appreciative of your brevity.

Since you have previously served on the Committee, you are well aware of the fact that all members of the Committee on Auditing Procedure have considerable correspondence. But you haven't seen anything yet. As Chairman, you will receive not only full Committee correspondence, but also correspondence

regarding all subcommittee activities, as well as not too infrequent communications from other members of the profession. Please take care of all of this promptly. I doubt that your Committee mail will take more than three or four hours a day, on the average, and probably will require no more than two-thirds of the time of your secretary, as a general rule. As with all general rules, however, there are exceptions -- it sometimes takes more. Be that as it may, you must dispose of each day's mail on its arrival. If you let it accumulate for two or more days, you will not see the top of your desk again during your term of office. This daily task of taking care of an important part of your profession's business will make it impossible for you to take a vacation, but I am sure you won't mind foregoing that pleasure.

As Chairman of the profession's top technical committee, all of us are looking to you for leadership. This will require you to make speeches to gatherings of fellow CPAs and other organizations, and you no doubt will need to devote a few weeks to composing appropriate remarks for these occasions.

You are at liberty to appoint any number of appropriate subcommittees, including a planning subcommittee, and even task forces of CPAs who are not members of the Committee, to deal with all sorts of special, or even routine, problems that will be confronting the profession. You should make full use of them, and I am sure you will. But there will be emergency matters where reference to these groups will not be possible. In those cases, use your own judgment. As a result of doing so, some of us will get pretty mad at you at times. Don't pay any attention to this, Ernie. Just go ahead and do what we would tell you to do if we knew what we were talking about. In that regard, be alert for anything that could be of interest to the profession and get it in motion quickly. Use the long distance telephone freely. That's often quicker and will save you a good deal of time, even if it won't save you money.

And speaking of time, you will find that the business of the Committee will often make demands on your time at the same moment some business of your firm, or your personal affairs, require attention. Now let me make this perfectly clear, Ernie. The Committee cannot be successfully operated by a Chairman who neglects the profession's business to take care of the needs of either his firm or his family. You simply must make arrangements to avoid having these matters distract your attention.

One more point, Ernie. There will be some trifling expenses for travel, secretarial help, postage, long distance calls, etc. The Institute's budget contains no provision for such expenses. I am sure you will relieve us of any embarrassment on this score by cheerfully absorbing your own costs. I offer no estimate of what the total may be. It is best, perhaps, for you to acquire this information gradually.

I mention these things, Ernie, not to suggest any misgivings as to whether or not they will be done, but to thank you sincerely for assuming these responsibilities for us. Also, I don't want to give the impression that you won't enjoy any part of your term of office. You certainly will, Ernie, I assure you. In fact, you may never enjoy anything more in your life than you will the conclusion of your term of office.

Good luck and best wishes,

Tom