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"Defensive Auditing - Taking the Offensive," Report to Council, Colorado Springs. Colorado, May 10 1971

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"DEFENSIVE AUDITING - TAKING THE OFFENSIVE"

A REPORT TO COUNCIL

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BY

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Introduction

Mark Twain once said, "It is better to deserve honors and not have them than to have honors and not deserve them." It might be well for us to stop occasionally and think about this philosophy, because it seems to me that the accounting profession deserves more honors than are being given us these days. For example, the Accounting Principles Board seems to get very little credit for its accomplishments, but at the same time it is criticized severely for not doing everything instantly. Of course, the APB should try harder. All of us should. But the Accounting Principles Board deserves more honors than it is getting.

We also hear complaints about how well the Committee on Auditing Procedure is doing its job, both from the viewpoint of quantity and quality. In view of my being Chairman of the Committee, I shall refrain from expressing an overall opinion on either the quality or quantity of its accomplishments. I will give you a piecemeal opinion, however, particularly as to the Committee's attitude and objectives.

In the first place, it is important to remember that in deciding what subjects to place on the agenda, and in reaching solutions to problems under consideration, the Committee on Auditing Procedure keeps in mind the following factors (in this order):

1. The public interest. (What are the legitimate needs of the users of our end product?)
2. Needs of the practitioner. (Is the problem, or the solution thereto, such that it will really help the practitioner do a better job?)
3. What are the legal implications?

Although contrary to what may appear to be popular belief, the Committee's basic philosophy is that the first two factors are overriding, and that the third(i.e., legal liability) is secondary or incidental. In theory, at least, legal liability should take care of itself if we do a good job and properly serve the legitimate needs of the public. I emphasize the word legitimate, because I sometimes have the feeling that some of the requests made of auditors serve no useful purpose other than placing the auditor in a position to be sued. As you may have heard me say before, I do not consider this, in and of itself, to be a legitimate need of the public. Consequently, the Committee certainly can, and often does, have situations in which legal liability becomes most important in resolving a particular matter.

So, what's the problem? The problem is that individual auditors, as well as the Committee on Auditing Procedure, are being accused in a derogatory way of practicing "defensive auditing." I have seen a few situations, and heard of others, in which practitioners have been accused by clients, bankers or underwriters (or lawyers representing one or more of these) of being too cautious in reporting or too demanding in audit evidence for the sole purpose of being in a better position to defend themselves in case something goes wrong. With litigation the way it is today, is it really any wonder that this should happen? This "protect yourself" attitude sounds bad for a professional of any sort who has the public interest primarily in mind, as contrasted to selfish or commercial interest. Although this sounds bad, I submit that it is not really all that bad. In fact, there's a lot to be said for this sort of auditor attitude from the viewpoint of the public interest. That is why I say we should take the offensive about defensive auditing.

We are not the only profession being accused of practicing defensively. The situation in the medical profession was summed up rather well by Dr. Stanley M. Hanfling in the September 19, 1970 issue of "Saturday Review." Doctor Hanfling said, "As a result of the threat of malpractice suits, physicians have begun to practice 'defensive medicine'. Additional lab tests, x-rays, and consultations are obtained, not for the benefit of the patient, but for protection of the physician, so that if he is accused of missing something, there is evidence to the contrary." This means that doctors are being much more careful in observing the third standard of field work; that is, obtaining "sufficient, competent evidential matter." In other words, having a good set of working papers. The doctors' patients, of course, are paying for this extra effort by the doctor to prepare this good set of working papers and thus protect himself. Naturally, the patients don't like this too much. Neither do our clients like it very much to pay for our extra efforts to protect ourselves.

Apparently, similar situations exist even in the legal profession. Lawyers are being more careful and practicing defensively, too. Although lawyers are the chief beneficiaries of the litigation explosion (more so than the public, in my opinion), they are not completely immune to its adverse consequences. In fact, at a recent Practising Law Institute seminar, one lawyer made the statement that insurance companies consider lawyers to be a worse risk than accountants. But doctors seem to be the worst risk of all the professions.

Recently Issued SAP's

As I said earlier, the Committee on Auditing Procedure also has been accused of practicing defensive auditing in its consideration of problems and issuance of Statements on Auditing Procedure. These accusations can go both

ways. On the one hand, if we require more evidence or procedures than have generally been customary, the contention is that the purpose is only to build a more extensive record for the auditor's self protection. On the other hand, anytime we say something less than maximum is ordinarily sufficient to satisfy professional standards, some think our purpose is to give the practitioner a defense (that defense being the enunciated standards of the profession) in case he gets in trouble. Let's take a look at some of the recently issued statements.

SAP No. 41 - Subsequent Discovery of Facts Existing at the Date the Auditor's Report

Some have suggested that SAP 41 is defensive for several reasons:

1. It says the auditor generally has no obligation to make further or continuing inquiry, or perform any other auditing procedures, after he has issued his report.
2. It strongly suggests that the auditor may successfully hide behind his attorney's advice to do nothing, even after he has discovered that financial statements he previously audited are wrong.
3. On the other hand, it also provides the auditor with a mechanism for protecting himself from further exposure, even at considerable risk of violating client confidences.

On balance, however, I believe everyone will agree that Statement No. 41 puts the auditor on the offensive. Sure, it is protective to some extent, but more importantly, it requires the auditor to do something and not sit idly by, all for the benefit of the public and possible detriment to his immediate client.

SAP 42 - Reporting When a Certified Public Accountant Is Not Independent

I have heard comments that this statement is defensive for these reasons:

1. Prior to SAP 42, the non-independent accountant could say he had made an audit, although he could not express an opinion. Obviously, when the type of report required by SAP 42 is issued, the auditor is less likely to be sued.
2. Each page of financial statements must be marked "unaudited", even though the accountant may have carried out all normal procedures. This is further protection against the accountant getting a lawsuit, and negative in client relations.

Are these factors really defensive? I suppose so, if that is the way you want to look at it. On the other hand, one could say they are offensive, or positive actions by the profession in the interest of the public, as contrasted to the narrow interests of our immediate clients. No doubt the adoption of SAP 42 has caused, and will continue to cause, non-independent CPAs to either make themselves independent or lose their clients to independent CPAs in many cases. I think this is all to the good. Even though it may be defensive, the more we can do to cause independent audits, as contrasted to work being performed by non-independent CPAs, the better off the profession is because the public is better served.

SAP 43- Confirmation of Receivables and Observation of Inventories

You may find it hard to believe that even SAP 43 has come in for some criticism on the basis of it being defensive auditing on four counts:

1. It says "other auditing procedures" should normally be greater if the independent auditor chooses to use the negative type of confirmation requests, rather than the positive type.

2. In effect, it gives an even stronger warning to the auditor that he had better think twice, or maybe three or four times, before he expresses an opinion if he has failed to observe inventories or confirm receivables.
3. For all practical purposes, it rules out completely the possibility of expressing an opinion if confirmation or observation procedures are omitted because of a scope restriction imposed by the client, regardless of the alternative procedures which may have been carried out.
4. As for "other auditing procedures" with respect to ending inventories, the statement provides that tests of accounting records alone will not be sufficient and that it will always be necessary for the auditor to make, or observe, some physical counts at some time.

What does all of this accomplish? Does it serve to put the auditor in a better position to defend himself in case he needs to do so? Yes, I think it does, so maybe it is defensive. More importantly, however these requirements strengthen the foundation for the independent auditor's opinion which adds credibility to financial statements, primarily for the benefit of third party users. Keep in mind, too, that while more exacting requirements in our professional literature serve to protect the auditor who has complied with these requirements, they also serve to place the non-complying auditor in a much more difficult position when attempting to defend his work.

Proposed SAPs

Some of the proposed Statements on Auditing Procedure now under consideration by the Committee also have come in for similar criticism. Let's take a look at some of the pronouncements we are considering.

Piecemeal Opinions

We have exposed to the entire membership of the Institute a proposed SAP which includes the following defensive auditing:

1. It clearly indicates that piecemeal opinions are dangerous from the auditor's viewpoint, and should be expressed only after doing extra work.
2. It almost entirely precludes expression of piecemeal opinions when a denial of opinion on the overall financial statements results from client-imposed audit scope restrictions.
3. It permits piecemeal opinions in client-imposed scope restriction situations only if the reports are clearly restricted to client management only or if the reports are clearly restricted for use by parties to a merger or buy-sell agreement.

Does this result in additional protection for the auditor and thus constitute defensive auditing? I suppose so, but here again the users of financial statements, particularly third party users which we refer to as the general public, will have a much better chance of reading only reports which are clearly understandable and reports which will add credibility in the minds of readers only to the extent justified in the circumstances. This is all to the good. We are attacking, or taking the offensive, by providing a better end-product and eliminating potentially misleading, if not actually misleading, reports.

Cold Comfort Letters for Underwriters

Several months ago, a proposed revision of SAP 35 was exposed to the profession and others, particularly the investment banking fraternity. The proposed revision makes it abundantly clear that the underwriter is responsible for determining what is necessary to discharge his responsibilities for a "reasonable investigation" under Section 11 of the Securities Act of 1933. Underwriters did not like this proposal to make this fact of life abundantly clear. Why? Because many of them had been whistling in the dark and thinking (maybe just hoping) the accountants were accepting the responsibility for discharging the underwriters' responsibility for a reasonable investigation under Section 11. The proposal is that comfort letters clearly spell out that the accountant is not accepting this responsibility. Obviously, such specific disclaimer would give more protection to the accountant and make him less susceptible to litigation in case something blows up.

I agree that this is defensive. But is this bad?

Representatives of the Investment Bankers Association have now recognized and acknowledged that their profession does indeed have a problem in meeting their statutory obligation to make a "reasonable investigation." They have also recognized that they cannot transfer that obligation to the auditor. So, an IBA committee is actively working on a solution to the problem, with assistance from the AICPA's Advisory Task Force on Comfort Letters, a group of SEC experts which is advising the Committee on Auditing Procedure. No doubt this project will result in some or all of the following:

1. Underwriters will become more familiar with problems of the companies which they underwrite, including accounting and auditing problems.
2. As a result of learning more, underwriters will no doubt be requiring audits of interim financial statements in more situations because they will no longer hide their heads in the sand, assuming that a comfort letter takes care of everything.
3. Underwriters undoubtedly will require auditors to carry out additional procedures above and beyond those required for the auditor to satisfy his own "reasonable investigation" responsibilities up to the effective date.

I suppose all of these could be labeled defensive auditing, except for the fact that most of these activities are not auditing at all, but instead are always something short of an audit. As you know, the profession has consistently refused to develop standards for "how not to make an audit" or "how to make half an audit." Anyway, auditing or not, they can be characterized as defensive, but that result is only incidental. More importantly, and completely overriding any defensiveness that may be involved, is the fact that underwriters will be coming a great deal closer to doing the job they are supposed to do, and as contemplated by Section 11 of the Securities Act. And, obviously, the investing public will be better served. I call this taking the offensive, not being defensive.

Internal Control

On the subject of internal control, the Committee is attempting to deal, among other things, with the problem of an auditor expressing an opinion on the adequacy of internal control, either the overall system or various phases

thereof. I think it is safe to say that no one has ever seen a perfect system of internal control. There are always some risks involved and there are wide differences of opinion about how much costs are justified in order to further minimize risk by getting closer to a perfect system. In view of these wide differences of opinion, and the impossibility of having one standard for the adequacy of internal control, what does a short-form, one-sentence accountants' opinion on the adequacy of internal control really mean to the uninitiated reader, particularly if the opinion is just a by-product of an ordinary examination of financial statements? We think they may very well give the reader all sorts of unjustified comfort. So, if these short-form opinions on internal control are misleading to the general public, they should not be published.

What should we do about this problem? The Committee is considering the following:

1. Prohibit, or at least discourage, publication of short-form one-sentence opinions on the overall adequacy of internal control as a result of an ordinary examination of financial statements, for the reasons already mentioned.
2. Give better guidance in the professional literature and encourage the practice of writing so-called management letters setting forth suggestions for improvements in internal control, and other recommendations, all as a result of the ordinary examination of financial statements. These, we believe, are very useful to management and others who have some familiarity with the system and are in a position to do something about deficiencies. I mean specific deficiencies, not just overall generalities.

3. Encourage special studies and special reports of a long-form nature with regard to specific phases of a system which, of course, may include all phases. These reports, as I see it, should deal with what work was done, what the accountants found, and recommendations for action. They require more extensive work than is necessary to satisfy the second standard of fieldwork with regard to making a proper study and evaluation of existing internal control in connection with planning an audit.

Is some or all of this defensive auditing? Yes, I suppose it is. But it also will result in the practitioner doing a more meaningful job and issuing more meaningful reports. This, in my opinion, is taking the offensive on behalf of the general public.

Revision of Short-Form Report

The Committee has had under consideration for at least four years the matter of revising the standard short-form report. We have developed several variations of a proposed new report, but I am not optimistic that one will be forthcoming soon. We also have drafted a Statement on Auditing Procedure which deals at some length with the philosophy underlying the various words and phrases in the proposed new short-form report.

Well, when are we going to get it published? I'm not promising anything because there are a lot of objections to the revision. Interestingly enough, the objections generally are that the whole thing is defensive. I'm afraid I have to agree that it does appear that way.

Our objective in revising the short-form report is not to avoid any legal liability. In fact, we are convinced that any revision we might make would not result in any avoidance of legal liability. Our entire objective is to better communicate with the users of our reports. Unfortunately, it is just that better and more clearer communication that makes the proposed revision appear defensive.

This may be a heck of a note, but we may decide that the public attitude about the profession right now is just not right to "tell it like it is."

Frankly, I can't make up my mind what we should do about this one. Since we are in the truth business, we should not be reluctant to tell the truth about exactly what we are doing and the credibility we are adding to financial statements. On the other hand, I am sympathetic to the proposition that this may not be the right time.

Conclusion

At about the time I was asked to make a report to this Council meeting, three things were fresh on my mind:

1. A Wall St. Journal article regarding lawsuits against doctors in which it stated that "Doctors...freely admit they are practicing medicine defensively these days to guard against potential suits."
2. Accusation by a client that my firm was demanding too much evidence in a particular situation in order to be in a position to defend ourselves against a lawsuit in case one should develop.
3. An accusation against the Committee on Auditing Procedure to the effect that the Committee was fostering defensive auditing.

These events caused me to decide I would like to report to Council on the subject of defensive auditing. At the time, I thought I could make a very good case for so-called defensive auditing not being defensive at all, it being more a matter of taking the offensive.

Something tells me I have not been too successful in my effort to take the offensive, but I do believe I have made a good case for defending defensive auditing and not being ashamed of it, because in all cases I think of, some of them mentioned earlier, the result is a better job for the benefit of the public.

Some of the same types of arguments were made back in 1948 and 1949 before Statement on Auditing Procedure No. 23 was adopted. You will recall that in those days it was not unusual for a CPA to issue a report, sometimes a rather lengthy one, reciting a number of things he had done, but when the work had not been sufficient to express an opinion on the financial statements, he would often not disclaim an opinion either. In considering the proposal that in all cases the auditor should either express an opinion or disclaim an opinion, some members of the profession felt this would be negative (or defensive) insofar as clients were concerned. Certainly that was right. Clients did not like it, but the profession recognized that it was more important to serve the needs, as best we could, of the third party users of financial statements on which we report. That primary emphasis on serving the needs of the public has continued, and has been emphasized, through all of the years since adoption of SAP 23. We see that philosophy ingrained in the recent pronouncements of the Committee on Auditing Procedure, as well as those now under active consideration.

So I say we should not be apologetic or defensive about defensive auditing. Instead, we should take the offensive and point out how virtually everything we do is focused toward the benefit of the public.

This does not mean we should ever lose sight of the needs of our clients. Certainly not. We should be striving to serve them better in all of our services. There is no question but what we should continually ask, "What can I do for my client?" But in auditing, we also had better be asking ourselves another question at the same time. That question is, "What is my client trying to do to me, and to the public?"