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Thomas L. Holton

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## "Change is the Challenge in Auditing"

by Thomas L. Holton  
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### Introduction

The 1969-1970 Committee on Auditing Procedure is the 30th such committee constituted by the AICPA. One might think that 30 years of diligent efforts by committee members devoted to improvements in auditing would have resulted in virtually all of the problems being solved. If you think that, then think again, because you are wrong.

Recognizing the multitude of current problems, some of the members of Council have been pressing rather hard recently to increase the production of the committee. Although I think this will come to pass, I must admit that, after chairing two committee meetings, I am not nearly as optimistic as I was in the beginning about performing some sort of miracle during the current fiscal year by disposing of a large number of the problems that have been on the agenda longer than I would like. I hasten to add, also, 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 a statement just for the sake of production. I do not think we should "publish or perish",

as they say in academic circles.

At the same time, my own thinking is that we should not continually postpone publication of the committee's current position just because we think it might have to be changed 3 to 5 years from now. Change can be good in some cases, even if another change occurs, say, 5 years later.

I have in mind particularly the matter of changing the standard short form report. The report in current usage has not been changed for about a quarter of a century, which is longer than a lot of us have been in practice. That's too long. Surely we can do better. Even if we can't do as much better as we would like, this may be a situation in which change for the sake of change would be good. I might add that I do not think changing the short form report will have any legal liability significance.

#### Cooperation with the SEC

I am a strong believer in the profession developing its own standards and staying ahead of their being developed by the courts, or by the SEC. This is not to say that we should not consider the views of the SEC in developing our own standards. We certainly should. Nevertheless, in the final analysis, we should develop our own and, if worse comes to worst, there may be different standards for SEC engagements and other engagements. I hope not.

Some recent developments indicate that the pro-

profession, the SEC and the public would be better served if the Committee on Auditing Procedure made a special effort to be more responsive to problems which the SEC can see developing. The profession recently demonstrated its ability to respond rather quickly in solving a major problem with franchise company accounting, although I must admit that the methodology was somewhat unorthodox. I'm sure you are familiar with what happened.

Right now a group working under the auspices of the Committee on Auditing Procedure is actively engaged in finding a solution to the problem of auditors' reports on development companies. There is close to complete lack of uniformity in reporting practices among members of the profession, and even within accounting firms. I am very hopeful that the committee will change this by issuing a limited scope statement this year dealing only with the appropriate rationale for auditors' reports on the special purpose financial presentations under Article 5A of Regulation S-X. I do not think it is possible to have a quick solution to the problem of reporting on regular financial statements of companies in the development stage and other companies in financial difficulties. However, this broader problem has been assigned to the subcommittee on degrees of qualifications, which was appointed in December.

By recognizing and being more responsive to the

problems that have been identified by the staff of the SEC, I would hope to avoid other situations similar to the events surrounding the issuance by the SEC of Accounting Series Release No. 115 in February of this year. As I am sure you are aware, this release deals with the problem of reporting on financial statements of a company which obviously is in trouble and about which there is a question as to its continuance as a going concern. Although I had assigned this problem to the subcommittee on degrees of qualifications in December, I must admit that I did not, at that time, fully appreciate the urgency of the matter in the eyes of the SEC. It was classified as just another problem, among the many, to be considered and hopefully resolved by the committee on the basis of recommendations of the subcommittee. Frankly, this was a situation where we did not react quickly enough and I think the final result was not as desirable as it might have been.

Somewhat in a state of desperation to solve the problem, the staff of the SEC handed us a draft of a proposed accounting series release one Friday and asked for consideration and comment the next week. As you gentlemen know, official consideration and action by a committee within one week is all but unheard of. In the circumstances, I called an emergency meeting of a group of SEC experts (the Advisory Task Force on Comfort Letters) on very short

notice. After several hours of discussion, the meeting adjourned and Dick Fitzgerald, chairman of our subcommittee on degrees of qualifications, and I drafted a letter of comment which we signed and mailed late the next Friday night, barely within the tight deadline. We then had a meeting with the SEC staff and Commissioner Needham on Tuesday of the following week, at which time the accounting series release was finalized for publication.

Our principal suggestions to the SEC regarding the proposed accounting series release were these:

1. Rather than interpret our profession's literature, and in effect, say to the whole world that the vast majority of practitioners were in violation of that literature, we thought the SEC should only interpret its own regulations as to what is and is not acceptable for filings under the Securities Act of 1933.
2. We felt strongly that the release should give accounting practitioners some useful guidelines as to what types of opinions are acceptable and what types are not acceptable.

We were successful with our first suggestion and I believe it is important that we were successful, particularly from the philosophical point of view of the profession establishing and maintaining its own standards.

We were not successful with our second suggestion and if you have tried to work with ASR 115, you know what I mean. Even though I was deeply involved in this matter from beginning to end, I am not satisfied with the advice I can give my own partners or other practitioners about what is and is not acceptable under the release. We warned the Chief Accountant, as well as the full Commission, of this problem prior to the release being issued. Hopefully, some clarification will be forthcoming after a reasonable amount of experience.

My purpose in dwelling on this matter is only to illustrate that some changes need to be made quickly. We must learn to cope more effectively with this fact of life.

#### New Applications of the Attest Function

In spite of all the criticism that is leveled against the accounting profession in the press and otherwise, I think it is fair to say that the profession has really progressed in stature during the last quarter century or so, and our clients, as well as the public in general, are demanding more of us. In the years ahead, the attest function by independent CPAs may be extended to a number of areas which would be rare, if not unheard of, today. I have in mind the following, among others:

1. Opinion on internal control at computer service centers. We are already experiencing situations

in which many firms of auditors whose clients use a particular service bureau must rely on reports of other auditors who have investigated the internal controls of the service bureau in detail and have expressed opinions with respect thereto. This seems to be the only answer, maybe not immediately but at least in the long run. But do we have well enough established standards to have reasonable assurance that accounting firms' opinions would not vary significantly? Don't we need better standards to make these reports really meaningful? The computer auditing committee is working on this.

2. Opinions on the adequacy or effectiveness of internal control in general. There are a few published auditors' opinions on their clients' internal control today, in spite of the fact that the profession has not developed standards by which to judge such controls for the purpose of an overall opinion. Several questions need to be answered. Is the review of internal control in connection with an ordinary audit sufficient for the auditor to be in a position to publicly express a formal opinion on the client's overall system? Does an overall opinion on internal control really mean anything? Or is the only mean-



ingful opinion one dealing with a specific aspect of the system? Is it possible to quantify evaluations of specific areas of internal control and also the overall system? Must statistical sampling techniques be used in order to so quantify and justify one's conclusion?

3. Infiltration of business by organized crime.

Should the CPA be in a position to give some sort of assurances (either positive or negative), that his client's procedures are such that an alert management will recognize any significant invasion of the business by organized crime? Business and the general public are concerned about this problem. Should we be working in the direction of being in a position to give the public some assurances along these lines? What is it worth? What are the CPA's risks?

4. Opinions on legal matters. I hear rumors that the legal profession would like to avoid writing the usual letters to auditors about pending litigation, etc. Hopefully, this philosophy will not spread, but if it does, must we then be in a position to assess the probable outcome of litigation ourselves? I understand that lawyers may be concerned about their own legal liability with regard to opinions

expressed in such letters. Now isn't that just too bad. Wouldn't it be just completely ridiculous to hold that lawyers have to be responsible for their professional opinions, just like accountants are held responsible for theirs.

5. Continuous auditing. Is it possible to develop auditing techniques, relying heavily on internal control, so that we would be in a position to give an opinion almost instantly at the end of any accounting period? The public may want it. But is it worth it, even if we can do it?
6. Auditing and reporting on human resources. You probably noticed in the press recently that one company is experimenting with reflecting its human resources in its financial statements. So far, these are unaudited, but if measurement of human resources becomes important, we must then be in a position to audit such measurements.
7. Opinions on forecasts. There seems to be widespread belief that the public wants the CPA to render opinions on forecasts. I would like to elaborate some on this one.

#### Reporting on Forecasts

All of us in public accounting practice have been

involved to one degree or another in making forecasts, or assisting clients with forecasts. I don't think anyone would say this is not a good and useful service for CPAs to render. We do it for clients all the time in our tax practice in connection with tax planning and preparing tax estimates. We assist clients in preparing data for their bankers in connection with obtaining bank loans. We help them make projections in connection with systems and procedures engagements. And, of course, I could name many more. Obviously, we get involved. Who else is better qualified to render a good professional service in this area? I don't think there can be any difference of opinion on this score.

We do have a significant difference of opinion within the profession, however, as to whether CPAs' reports on forecasts should be used in connection with the sale of securities to the public. Some firms will permit their reports to be used in this manner. Other firms will not. The feeling of the latter group is that, in spite of disclaimers of responsibility for the actual results turning out essentially the same as projected results, the man on the street cannot be expected to understand the limitations of the credibility we add to the forecasts. So he would inevitably attribute more significance to our name being associated with such forecasts than would be warranted.

Those on the other side of the argument contend, quite logically, that we as professionals should be capable of writing understandable reports that properly limit the amount of credibility that is being added by having our name associated with forecasts.

One of the problems here, unfortunately, is that we CPAs have been too successful in having the public believe we are infallible and that the financial statements on which we report are absolutely precise and accurate. This is in spite of the fact that we have tried for many years to educate the public otherwise.

Maybe we have a unique opportunity here, in connection with forecasting, to give the proper impression to the public by insisting that there be at least two, and possibly more, projections of probable or possible future results -- an optimistic, a pessimistic and another presentation in between the two, representing some sort of reasonable expectation. Should we then express an opinion on the reasonableness of the assumptions used? Or should we merely express some sort of negative assurance with regard to them? Or neither?

In view of the fact that projections never turn out to be right, would our public association with these documents lead to a feeling on the part of the public that a CPA's attestation is not very reliable? Also, would

CPAs be held to a stricter standard, legal liability wise, than other professionals or semi-professionals who report on forecasts? Would our having reported on forecasts in some way jeopardize our independence with regard to subsequent auditing of historical results? Just what standards should be developed as guidelines for CPAs in permitting their names to be associated with forecasts?

I don't have all of the answers. In fact, I don't even profess to have all the questions. It does seem to me, however, that we should be working at some of the solutions. And we are.

#### Auditing Research

The forty-two statements that have been issued by the Committee on Auditing Procedure during the past thirty years have been produced almost entirely by the committee members themselves. As a practical matter, no research staff at the Institute has been available to the committee. This situation has changed recently and I am very pleased that the committee now has available the services of Douglas Carmichael, the new manager of auditing research. Doug has helped, and will continue to help, the committee considerably. I hope everyone realizes, however, that this should only be the beginning. Additional staff must be made available, if we are to do the job we should do.

This matter of not having a research staff has always been a problem of the committee. Chairmen have complained of this deficiency for many years, at least as far back as the late 1950's when I served as a member of the committee.

Surely if you think about it, you are amazed as I am, that there is such an imbalance in the amount of research effort devoted to accounting principles, as contrasted to auditing standards and procedures. I think one reason for this is that we are professional people devoted to serving the needs of our clients. Accounting is more directly related, or at least more obviously related, to client problems. Auditing, on the other hand, is basically our own problem, instead of being immediately and directly client related. This rather natural attitude about serving the needs of our clients is hard to criticize, but sooner or later we have to take care of ourselves, too. Otherwise, service to clients will eventually deteriorate.

I would like to mention just a few of the backlog of research projects which I believe additional staff should be working on for the benefit of the profession. Some of these are receiving Doug Carmichael's attention, but he can't do everything.

1. Degrees of qualification of opinions on finan-

cial statements.

2. Reports on interim financial statements. (This is, of course, also related to the problem of continuous auditing and instant opinions.)
3. Opinions on forecasts, which I mentioned earlier.
4. Opinions on gambling casinos, particularly with regard to the control of cash receipts.
5. Proper reporting on development companies and other companies in financial difficulties.
6. Reporting on supplementary financial information, including price level financial data.
7. Determining genuineness of inventories and other problems involving inventory observation techniques, when to observe inventories, how to observe inventories and how much to observe.
8. Effectiveness of confirmation procedures, both negative and positive.
9. Reliance on other experts.

#### Functioning of the Committee

Members of Council may be interested in a number of respects in which we are gearing up for change and attempting to increase the effectiveness of the committee's work. I will mention several of these briefly:

1. The committee is now meeting every other month rather than once every three months, as has been

the case in recent years.

2. Departing from previous practice, virtually all subcommittee meetings are to be held separate and apart from the place and time of full committee meetings. With the accelerated pace of full committee meetings, this has placed considerable pressure on the subcommittees to make progress in a shorter period of time.
3. Because of the multitude of problems, or what I refer to as backlog, I am giving some thought to the advisability and practicality of the committee issuing an omnibus statement on auditing procedure each year covering several unrelated, but nevertheless important, subjects that would not individually justify issuance of a statement on auditing procedure.
4. We expect to devote less time in full committee meetings to reporting on progress and more time to concentrate on discussions of topics on which we are about to make pronouncements.
5. We now have a planning subcommittee which has as one of its responsibilities the assignment of priorities for the multitude of projects we have under active and semi-active consideration.
6. I think we should take a new look at the authority,



objectives and method of operation of the committee. I don't necessarily believe these should be changed, but I do believe they should be re-evaluated. As far as authority is concerned, I doubt that there is too much of a problem. As for objectives, possibly there should be more efforts in the direction of the philosophy of auditing, at one end of the spectrum, and also more in the area of auditing procedure guidelines or "how to do it," which is completely at the other end of the spectrum. I would characterize most, but not all, of the committee's pronouncements to date as being "down the middle," or about midway in between these two extremes. As for method of operation, I mentioned earlier that we definitely need more research assistance. Without it, progress is not only too slow, but I fear that conclusions may be reached on the basis of hunch, rather than on the basis of conclusive evidence that imperical research may produce.

7. More projects should be undertaken by specially constituted task forces under the auspices of the committee, rather than doing all of the work ourselves. The Advisory Task Force on Comfort Letters is a very good case in point.

8. I have given considerable thought to the proposal to eliminate both the Accounting Principles Board and the Committee on Auditing Procedure and consolidate their present responsibilities in a newly created small body of full-time people. The reason advanced has been that accounting and auditing are so inter-related that the two cannot be completely separated. Obviously, there is some merit to this suggestion. On balance, however, I do not believe such a consolidation to be desirable. One of the principal reasons for this conclusion is that I am afraid auditing would get too little attention in such an environment of dual responsibility. Again, I refer you to the Institute's research efforts as evidence of this.
9. I also have in mind recommending that the committee be reconstituted as the Auditing Standards Board, or maybe just renamed the Auditing Standards Board. The term "auditing procedures" is entirely too narrow, in my opinion. In the first place, I think there can be little doubt that a great deal of our work does deal with standards, as contrasted to procedures. On the other hand, the broader term "standards" would in no way preclude the group dealing with procedures in appropriate circumstances,

of which there may be many. The term "Board" is suggested instead of "committee" because it indicates more authority and stature, notwithstanding some of the recent remarks about the Accounting Principles Board.