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Independent auditors' responsibilities and the audit report; Technical Research Report 1

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by Paul Rosenfield and Leonard Lorensen

AICPA American Institute of Certified Public Accountants

INDEPENDENT AUDITORS' RESPONSIBILITIES
AND THE AUDIT REPORT

By

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CONTENTS

Director's Preface

Ever since the Special Committee on Opinions of the Accounting Principles Board highlighted the problem in 1965, the meaning of the phrase "present fairly" in the auditor's report has been debated by accountants. Recently, the financial press, the courts, and securities regulators have entered the fray. And the debate has expanded beyond determining what auditors mean when they use "present fairly" to include consideration of what responsibilities auditors should take in expressing opinions on financial statements. That is the crux of the problem. Changing the words in the audit report to better describe what is meant by "present fairly" would accomplish little without agreement on the auditor's responsibilities.

This technical research report was prepared by Paul Rosenfield and Leonard Lorensen. They identify the alternative responsibilities, summarize the positions taken on those alternatives by major spokesmen, and evaluate those positions. In my view, their report clarifies many issues on which confusion has reigned and is a significant step toward the solution of a complex problem. At the time this report was prepared both Mr. Rosenfield and Mr. Lorensen were project managers in the technical research division. Mr. Rosenfield is now Secretary to the International Accounting Standards Committee.

From time to time, the technical research division will prepare reports of this type analyzing current problems and alternative solutions, supported by the necessary background material, to be used as a basis for discussion. Comments and criticisms are invited.

D. R. Carmichael
Director of Technical Research

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Independent Auditors' Responsibilities and the Audit Report

Turmoil exists over the responsibilities of independent auditors as reflected in the auditor's standard report. The report is widely criticized as being unclear and authoritative bodies have issued conflicting interpretations of the report. The restated code of professional ethics suggests new and uncharted responsibilities. The courts have started to base decisions on their own interpretations of auditors' responsibilities. And spokesmen for the public accounting profession, the SEC, and stock exchanges call for increased responsibility for auditors.

The Auditor's Report—What Does It Mean?

The auditor's standard report includes the auditor's opinion that the financial statements present fairly the financial position of the enterprise at the balance sheet date and the results of operations and changes in financial position for the period ending on the balance sheet date, in conformity with generally accepted accounting principles. The meaning of "present fairly" and the relationship between that phrase and "in conformity with generally accepted accounting principles (GAAP)" are not clear and have been variously interpreted. Analyzing possible interpretations provides a framework to describe present responsibilities of independent auditors and to propose changes in those responsibilities.

Several interpretations have been suggested. We believe they fall into one of three categories that together comprehend the varieties of responsibilities that independent auditors are now taking plus those that they are being asked to assume. The following are concise statements of the three interpretations:

Interpretation No. 1: The presentation is in conformity with GAAP and therefore the presentation is fair.

Interpretation No. 2: The presentation is in conformity with GAAP and the presentation is fair.

Interpretation No. 3: The presentation is in conformity with GAAP and GAAP have been fairly applied.1/

Each of the interpretations in effect consists of two ideas. The first idea is the same in all interpretations: the presentation is in conformity with GAAP. The second is different in each of the interpretations:

a. Conformity with GAAP results in fair presentation.

b. The presentation is fair.

c. GAAP have been fairly applied.

The controversy over the meaning of the auditor's report rests on the question of which of those second ideas is intended. Moreover,

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1/ The Special Committee on Opinions of the Accounting Principles Board (1965) listed several possible interpretations in its report (p. 14).

> (1) that the statements are fair and in accordance with generally accepted accounting principles; or (2) that they are fair because they are in accordance with generally accepted accounting principles; or (3) that they are fair only to the extent that generally accepted accounting principles are fair; or (4) that whatever the generally accepted accounting principles may be, the presentation of them is fair.

The Committee's first two interpretations agree with the first two in this paper. The Committee's third interpretation does not seem to be a reasonable way to read the language of the report. The Committee's fourth interpretation is not clear but seems to be similar to the third interpretation in this paper.

the turmoil over auditors' responsibilities can be understood mainly as a dispute over which of those ideas reflect responsibilities auditors now take and which reflect responsibilities they should take.

The Basic Standard—Conformity With GAAP

Collective Responsibility to Establish GAAP. The responsibilities of independent auditors center on the establishment and use of standards by which to appraise financial statement presentations. Establishing GAAP is a collective responsibility. The profession as a whole or authoritative bodies determine the accounting principles that are to be considered as part of generally accepted accounting principles. Each of the three interpretations of the auditor's report requires an auditor to use that collective standard.

Should GAAP Be a Rule Book? The first interpretation of the auditor's report—the presentation is in conformity with GAAP and therefore the presentation is fair—makes fair presentation a result of conformity with GAAP; fair presentation is not appraised by a separate standard under that interpretation. The interpretation therefore confines the standards used to appraise presentations to the collective standard.

The first interpretation might even imply that GAAP ideally should be a rule book that can be followed without the exercise of personal judgment by the individual auditor. That view has support. For example, a significant group of participants at the second Seaview symposium argued

> that the route to improved reporting was a more comprehensive and specific definition of accounting principles which would then represent fairness

> as generally agreed upon by an authoritative professional body.2/

One participant in the symposium even contended that accounting in particular situations should also be decided collectively:

> If fairness is a subjective judgment, shouldn't a body of really independent professionals make that judgment based on the facts of a particular case rather than leaving the judgment to the management or the auditors in the case where no specified principles exist? This is an alternative to attempting to codify everything at once.3/

Compulsion to Approve GAAP. Although the individual auditor is not required to use another standard under the first interpretation, he is compelled under that interpretation to approve GAAP publicly in every report he signs. He is required under the interpretation to state that he personally approves of the presentation because it meets the standard adopted by his profession.

Should Individual Auditors Also Apply Their Own Private Standards?

Rather than being compelled to personally approve a presentation because it conforms with GAAP, an individual auditor could be asked to state what he really believes about the financial statements based on his own private standard completely apart from GAAP in addition to giving his opinion on conformity with GAAP. That responsibility is implied by the second interpretation of the auditor's report—the presentation is in conformity with GAAP and the presentation is fair.

GAAP do not represent the unanimous view of accountants on good accounting. Rather, GAAP are determined by sorting out

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2/ John C. Burton, "Symposium on Ethics in Financial Reporting," The Journal of Accountancy, January 1972, p. 48.

3/ John C. Burton, Editor, Corporate Financial Reporting: Ethical and Other Problems (New York: AICPA, 1972), p. 23.

conflicting views. Many accountants do not personally approve of specific results of that sorting out process but agree to accept the process for the good of the profession and the public. The accounting literature is replete with personal views that GAAP do not give a fair presentation. That is the natural result of asking individuals to subordinate their personal views to a general consensus. The authors of those views often would find that in their personal judgment a presentation not in conformity with GAAP is required for a fair presentation.

Arthur Andersen & Co., for example, once stated:

> Principles and practices that we suggest and for which there is some recognition and acceptance are not always followed by our clients in their accounting and financial statements when other principles and practices are considered to be "generally accepted." In such cases, we must give careful consideration and apply our judgment in the light of all the facts as to when clear disclosure of the effect of the practices followed is necessary for a fair presentation of the financial statements, and when an exception to the practices followed should be taken in our auditors' opinions.4/

Larger reservations were voiced by F.J.O. Regan, the Australian official responsible for the administration of the Companies Act and by Philip L. Defliese, the chairman of the Accounting Principles Board:

> By what feat of semantic legerdemain can a balance sheet, consisting of a conglomeration of amounts arrived at on the basis of cost or at a valuation other than cost, each referable to numerous and unspecified points of time, be said to give shareholders, or any other group for that matter, a true and fair view of the state of affairs of the company as at the end of the period to which it relates?5/

4/ Arthur Andersen & Co., Accounting and Reporting Problems of the Accounting Profession, Third Edition—November 1969, p. 4.

5/ F.J.O. Regan, "'A True and Fair View,'" Abacus, December 1967, p. 97.

> The auditor's familiar imprimatur of the balance sheet: that it "presents fairly the financial position" would be a flagrant lie if it were not for the added reassuring qualifier, "in conformity with generally accepted accounting principles."
> The concept of financial position, which would not even be particularly useful if it could be effectively presented—and it cannot—must be dethroned.6/

Mr. Regan and Mr. Defliese do not merely indicate their personal belief that applying GAAP in the balance sheet does not present fairly the state of affairs or financial position of the enterprise at the balance sheet date. They imply their personal belief that a balance sheet does not even address the state of affairs or financial position of the enterprise at the balance sheet date, that the balance sheet does not present the state of affairs or financial position—fairly, unfairly, or in any other manner.

✓ Since an individual auditor can have a personal opinion that a presentation in conformity with GAAP is not fair and that a presentation in conformity with principles that are not generally accepted is fair, requiring him to state separate opinions on conformity with GAAP and conformity with his private standard of fair presentation would cause him to draw one of four possible conclusions:

1. The presentations conform with GAAP and are fair.
2. The presentations conform with GAAP and are not fair.
3. The presentations do not conform with GAAP and are fair.
4. The presentations do not conform with GAAP and are not fair.

6/ Philip L. Defliese, The Objectives of Financial Accounting (New York: Coopers & Lybrand, 1973) p. 6.

Appraising the Application of GAAP—
How Far Should the Auditor Go?

Regardless of whether an auditor is required to appraise financial statement presentations based on his own private standard completely apart from GAAP, he can be asked to use his individual judgment in appraising the application of GAAP to particular circumstances. That responsibility is implied by the third interpretation of the auditor's report—the presentation is in conformity with GAAP and GAAP have been fairly applied.

Although, as noted earlier, a few accountants believe that GAAP should ideally be a rule book that eliminates the need for individual judgment, there is general agreement that GAAP is not a book of rules that can be followed blindly. An auditor must appraise the application of GAAP in many areas; the standard he uses is his personal judgment of a fair application of GAAP in the circumstances.

Present Responsibilities to Appraise the Application of GAAP. Individual auditors are now responsible for exercising individual judgment in appraising the application of GAAP in areas such as the following:

1. Complexity of Events. Some events are so complex that an auditor must use his judgment to determine the substance of the events.

2. Substance Over Form. Auditors must use judgment to determine whether the substance of events differ from their form and whether events whose form and substance differ are accounted for in accordance with their substance.

3. Continuity of Events. Many events are continuous and start before and end after balance sheet dates. Auditors must use judgment to determine that the cutoff conforms with GAAP.

4. Predictions. Some GAAP require predictions, for example, lives of depreciable assets. An auditor must use judgment to appraise predictions used in applying GAAP.

5. Materiality. Small items are sometimes given simple treatments that are not in conformity with GAAP. An auditor must use judgment to determine whether the departures from GAAP are material.

6. Adequate Disclosure. Adequate disclosure is part of GAAP7/ but is not confined to a set of detailed instructions that need simply to be followed. A few rules exist8/, but the requirement to appraise the adequacy of disclosure within GAAP goes beyond those rules and presents a wide latitude within which the auditor must use his individual judgment.

The interpretation of "present fairly" as meaning that GAAP require judgment in their application in areas such as those listed and cannot be followed by rote to arrive at "correct" financial statements was expressed in the AICPA booklet Forty Questions and Answers About Audit Reports published in 1956 (page 11):

> What is the significance of the expression "present fairly" in the CPA's report?
>
> The values of many items in financial statements cannot be measured exactly. The items which, in part at least, are subject to approximation are among the most important in the financial statements, such as inventories and provisions for current costs expected to be paid in the future. Because of this, no one can be in a position to state that a company's financial statements "exactly present" financial position or results of operations. Accordingly, the CPA usually states that the financial statements "present fairly" in the sense that he believes they are substantially correct. For the same reason, his findings are expressed in the form of an opinion. However, it should be borne in mind that the judgment involved is an informed one, and is guided by generally accepted accounting principles.

7/ APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, par. 199; Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, Section 540.01.

8/ Some are stated, for example, in APB Statement No. 4, pars. 190-201.

Essentially the same thought was contained in a similar booklet, The Auditor's Report, published by the AICPA in 1967 (pages 12-13):

> Accounting for business transactions requires approximations and estimates. Unlike certain fields of science where a specific result can be achieved by the combination of certain elements, the amounts of many items in the financial statements cannot be measured with exactness but are subject to the application of professional judgment on an informed basis. Therefore, when the auditor refers to fairness of presentation, no claim is being made as to precise exactness. Rather, the auditor is saying that within a reasonable range of materiality, the financial statements have been presented on a basis which is fair to all segments of the financial community.

Enlarging the Responsibilities to Appraise Application of GAAP. The extent to which the independent auditor should be responsible to appraise the application of GAAP is unsettled. Calls for enlarged responsibilities, for responsibilities to exercise judgment in areas beyond those listed above, abound. They are detailed in subsequent sections of this paper, but they all have a common thread: they ask that the auditor go beyond an appraisal of the particular application of GAAP in individual line items and specific disclosures in financial statements. Some ask that he appraise the effect of all the applications of GAAP on the financial statements as a whole. Others ask that if the auditor prefers an alternative principle to the principle actually used that he indicate his preference even though both principles are generally accepted.

Summary of Implied Responsibilities

To summarize, all interpretations of the auditor's report imply that the auditor is responsible for determining whether the financial statement presentations conform with GAAP. The first interpretation implies that an auditor is compelled to state that he personally approves of a presentation because it conforms with

GAAP. The second interpretation implies that an auditor is responsible for appraising financial statement presentations based on his own private standard completely apart from GAAP in addition to appraising conformity with GAAP. The third interpretation implies the responsibility for the auditor to appraise the application of GAAP in the circumstances; the extent to which that appraisal should go is not settled.

Conflicting Official Interpretations

The American Institute of CPAs and The Canadian Institute of Chartered Accountants both recommend the same auditor's report. The AICPA does not explicitly interpret the responsibilities implied by the report but its interpretation can be inferred from its official pronouncements. The CICA explicitly interprets the report. The interpretations of the AICPA and the CICA conflict.

In its Statement No. 4 (paragraph 189), the AICPA Accounting Principles Board discussed fair presentation in conformity with GAAP:

> The qualitative standard of fair presentation in conformity with generally accepted accounting principles of financial position and results of operations is particularly important in evaluating financial presentations. This standard guides preparers of financial statements and is the subjective benchmark against which independent public accountants judge the propriety of the financial accounting information communicated. Financial statements "present fairly in conformity with generally accepted accounting principles" if a number of conditions are met: (1) generally accepted accounting principles applicable in the circumstances have been applied in accumulating and processing the financial accounting information, (2) changes from period to period in generally accepted accounting principles have been appropriately disclosed, (3) the information in the underlying records is properly reflected and described in the financial statements in

> conformity with generally accepted accounting principles, and (4) a proper balance has been achieved between the conflicting needs to disclose important aspects of financial position and results of operations in accordance with conventional concepts and to summarize the voluminous underlying data into a limited number of financial statement captions and supporting notes.

That discussion implies that the auditor is responsible for determining if GAAP is properly applied but that he is not responsible for appraising presentations based on his own private standard completely apart from GAAP.

In Statement on Auditing Procedure No. 33, the AICPA Committee on Auditing Procedure also implied that the auditor is not responsible for appraising presentations based on his own private standard completely apart from GAAP, but it went further and implied that the auditor must personally approve of the presentation because it conforms with GAAP. SAP 33 (page 63) listed as a reason to depart from the standard short-form report:

> The financial statements do not present fairly financial position or results of operations because of:
>
> (1) Lack of conformity with generally accepted accounting principles
>
> (2) Inadequate disclosure.

Since the Committee gave no other reason for the absence of fair presentation, it implied that conformity with GAAP and adequate disclosure necessarily result in fair presentation. The successor Auditing Standards Executive Committee modified that language in Statement on Auditing Standards No. 1 (Section 540.01), which no longer discusses fairness of presentation in connection with departures from the standard report. However, the discussion still implies that the auditor is not required to appraise presentations based on his own personal standard completely apart from GAAP.

In contrast, in the CICA Handbook (Section 2500.08) the Canadian Institute requires auditors to fulfill the following responsibilities:

> The auditors should express an opinion, or report that they are unable to express an opinion, as to whether:
>
> (a) the financial statements present fairly the financial position of the enterprise, the results of its operations and, where applicable, the source and application of its funds, and
>
> (b) the financial statements were prepared in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding period.

That interpretation makes the auditor responsible for giving two separate opinions, one on conformity with GAAP and one on fairness of presentation based on the auditor's own private standard completely apart from GAAP. Just to make sure it was not misunderstood, the Institute authorized a letter to be sent to all members reconfirming that interpretation. The letter stated that a departure from GAAP requires a qualified opinion but only as to conformity with GAAP. But

> This does not mean that auditors must necessarily qualify their opinion as to whether the financial statements present fairly the financial position of the enterprise, the results of operations and, where applicable, the source and application of its funds. That decision is a separate matter of professional judgment on the part of the auditors....9/

9/ Letter dated May 16, 1972 to the Members of The Canadian Institute of Chartered Accountants from Gertrude Mulcahy, Director of Research, for the Accounting and Auditing Research Committee. A note at the bottom of the letter stated that the letter "should be read as though it were part of Section 2500 of the CICA Handbook...."

Thus, the CICA interprets the report as requiring the auditor to appraise presentations based on his own private standard completely apart from GAAP, and the AICPA interprets the same report as not carrying that requirement.

Recent Developments Concerning "Present Fairly"

Several important recent developments can be understood in terms of the responsibilities they imply that auditors should take in expressing an opinion. Those developments include the revision of the AICPA's code of professional ethics, court cases that were decided on the basis of interpretations of auditors' responsibilities, and calls for enlarging or clarifying auditors' responsibilities by public officials, leaders of the profession, and others.

Does the Restated Ethics Code Impose New Responsibilities? Rule 203 of the *Restatement of the Code of Professional Ethics* of the AICPA requires the auditor to exercise his individual judgment, but does not make clear whether his responsibility is to appraise the application of GAAP or to appraise the presentation based on his own private standard completely apart from GAAP:

> Rule 203—Accounting principles. A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the body designated by Council to establish such principles which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. In such cases his report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

The rule requires certain disclosures if an auditor can demonstrate "unusual circumstances" but does not indicate explicitly what the auditor should state about conformity with GAAP. Interpreting the rule requires analysis of its first sentence, which is long and involved. The sentence is in the following form: An auditor may not do A if B exists unless the auditor can do C, in which

A is express an opinion that financial statements are presented in conformity with GAAP

B is the statements contain a departure from an accounting principle promulgated by the body designated by Council to establish such principles [such as the Financial Accounting Standards Board (FASB)] which has a material effect on the statements as a whole

C is demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading.

A statement of that form can reasonably be interpreted as saying that the auditor may do A if B exists and the auditor can do C. That is, the auditor may still express an opinion that financial statements containing a material departure from a pronouncement of the body designated by Council, such as the FASB, are in conformity with GAAP if he can demonstrate that unusual circumstances require the departure to make the statements not misleading.

The implication of that interpretation is that the treatment required to make the statements not misleading, which is a departure from a pronouncement of the body designated by Council, is in conformity with GAAP. In unusual circumstances, GAAP as represented by an FASB pronouncement should not be applied and other GAAP should be applied. That interpretation of Rule 203 directs the individual judgment required by the rule to the application of GAAP.

An existing interpretation, number 203-1, implies the same responsibility. It states that "Examples of events which may justify departures from a principle are new legislation or the evolution of a new form of business transaction." R. K. Mautz and Hussein Sharaf suggested a method of evaluating accounting principles developed for new types of business transactions and activities not covered by GAAP:

> When unusual cases arise in court they call for a process of reasoning by analogy from similar cases and from broad principles extracted from previous litigation. When they arise in audits, again they call for reasoning by analogy from similar audit situations and from broad principles based on previous applications of generally accepted accounting principles.10/

Accounting principles developed that way are extensions of GAAP rather than departures from GAAP—they represent application of the spirit rather than the letter of GAAP. They require individual judgment directed to the application of GAAP.

The restated code therefore requires the auditor to appraise the application of GAAP but does not require him to appraise the presentations based on his own private standard completely apart from GAAP.

Have the Courts Imposed New Responsibilities? In the absence of clear statements by the profession of independent auditor's responsibilities and unambiguous reflection of those responsibilities in the auditor's report, governmental bodies may impose responsibilities that are not contemplated by auditors or that are not warranted. In the Continental Vending case[11/], the federal court found that auditors'

10/ R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (American Accounting Association, 1961), p. 167.

11/ United States v. Simon, et al., 425 F.(2d) 796 (2nd Cir. 1969) CCH Fed. Sec. Law Rep., pars. 92, 511.

responsibilities were not clear and decided the case based on its own views of those responsibilities. Those views were stated in terms familiar to the court, not in terms commonly used by auditors. They must be analyzed to determine if they impose new or unwarranted responsibilities on auditors.

The defendant auditors were convicted of conspiring to omit from the financial statements of Continental Vending material facts of which they were aware. The court found that the financial statements omitted material facts, principally because they did not state (1) that a receivable from a company controlled by a major stockholder of Continental Vending was essentially a loan to the stockholder who used the other company as a conduit for the loan and was unable to repay it, and (2) that the "marketable securities" that served as collateral for the receivable consisted of stocks and bonds of Continental Vending.

The defendants contended that they had followed generally accepted auditing standards in their examination of the financial statements and that in the course of their examination had reached an opinion that the statements conform with GAAP.

The trial judge instructed the jury that the "critical test" was whether the financial statements "fairly presented the financial condition of Continental as of September 30, 1962" and whether they "accurately reported the operations for fiscal 1962."12/ He instructed the jury to consider proof of compliance with professional standards as "evidence which may be very persuasive but not necessarily

12/ United States v. Simon, et al., 66 CR831 USDC Southern District of New York, Tr. p. 3982.

conclusive" that the financial statements "were not materially false or misleading."13/

In their appeal, the defendants contended that the trial judge had erred in instructing the jury to decide on the basis of fair presentation rather than on the basis of compliance with professional standards. In its amicus brief before the Appeals Court, the AICPA contended that as a result of the instructions:

> ...the jury was left, insofar as it may have chosen to disregard standards of the accounting profession, either to its own unguided judgment or, more likely, to some concept of what a reasonably prudent investor would expect by way of disclosure or inquiry.14/

The brief further contended:

> The test of investor or stockholder interest against which the jury may thus have tested the defendants' conduct as to the disputed matters of disclosure and inquiry could well have led to markedly different results than would the application of the professional standards the defendants had undertaken to follow.15/

The Appeals Court upheld the decision of the trial court and disagreed that the trial judge had erred in his instructions to the jury:

> We do not think the jury was...required to accept the accountants' evaluation whether a given fact was material to overall fair presentation, at least not when the accountants' testimony was not based on specific rules or prohibitions to which they could point, but only on the need for the auditor to make an honest judgment and their

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13/ Ibid., p. 3981.

14/ Amicus brief, p. 29.

15/ Ibid.

> conclusion that nothing in the financial statements themselves negated the conclusion that an honest judgment had been made.16/

The Court of Appeals thus considerably limited the extent to which a jury may determine a case apart from standards of the profession. David B. Isbell, an attorney who helped prepare the amicus brief of the AICPA, stated that

> ...the Court of Appeals...[limited] its holding that less then conclusive weight may be given to professional standards to cases where such standards involve no specific rules or prohibitions but leave the matter to the judgment of the individual auditor. The Court's "at least" implies that in cases where there are specific rules or prohibitions they may be conclusive. This also is what the BarChris case suggests: "Accountants should not be held to a standard higher than that recognized in their profession." (Escott v. BarChris Construction Corp., 283 F. Supp. 643, 703 (S.D.N.Y. 1968)).17/

Isbell drew the following lesson for the profession from the Continental Vending case:

> For the profession the case points out once more the very real advantage, at least from the point of view of legal responsibility, in having professional standards spelled out. Had there been specific rules or prohibitions governing the matters about which there was dispute among the expert witnesses in this case, to which the defendants could refer, it is quite probable the result would have been different. There would very possibly have been different instructions; very likely a different verdict; and altogether likely, if neither of those had occurred, a different decision by the Court of Appeals.18/

16/ Opinion of the Court of Appeals, reprinted in The Journal of Accountancy, February 1970, p. 66.

17/ "The Continental Vending Case: Lessons for the Profession," The Journal of Accountancy, August 1970, p. 36.

18/ Ibid.

The Court of Appeals was clearly saying that auditors must exercise individual judgment in areas in which no specific rules or prohibitions exist to determine that statements are not misleading. But it apparently was not asking auditors to judge individual rules or prohibitions that do exist. The Court was in effect asking auditors to appraise the application of GAAP, including adequate disclosure, but was not asking auditors to appraise presentations based on their own private standards completely apart from GAAP.

Calls for Enlarged Responsibilities. Calls by influential leaders for enlarging auditors' responsibilities have reached a crescendo. The statements of those leaders do not explicitly describe the added responsibilities they would have auditors assume, and the statements therefore require interpretation. It is even possible that a reasonable interpretation of the statements would differ from the meanings intended.

Calls to apply private standards. The statements of many influential leaders can be interpreted as saying that auditors' responsibilities should be expanded to include appraisal of financial statement presentations based on the auditors' own private standards completely apart from GAAP, although that might not have been their intention. For example, the Comptroller General of the United States issued a guide in 1972, Standards for Audit of Governmental Organizations, Programs, Activities & Functions, which can be interpreted as including that added responsibility (page 49):

> Each audit report containing financial reports shall:
>
> 1. Contain an expression of the auditor's opinion on whether the information contained in the financial reports is presented fairly. If the auditor cannot express an opinion, the reasons therefor should be stated in the audit report.

2. State whether the financial reports have been prepared in accordance with generally accepted or prescribed accounting principles applicable to the organization, program, function, or activity audited and on a consistent basis from one period to the next.

The testimony of Alexander Grant & Company before the Accounting Objectives Study Group can be interpreted as making the same recommendation (page 6):

> We suggest an auditors' opinion along the following lines:
>
> In our opinion, the financial statements of XYZ Industries, Inc. (which do not necessarily reflect economic values) in all material respects:
>
> a. Fairly reflect the underlying transactions and events.
>
> b. Are based on the application of accounting and reporting standards which conform to published standards of the American Institute of Certified Public Accountants (and the Financial Accounting Standards Board).

The same interpretation can be placed on the recommendation made by the President of the AICPA, LeRoy Layton, in his address at the Institute's annual meeting on October 4, 1972:

> Once the auditor, supervisor or reviewer determines that all published standards have been complied with, he should figuratively step back, take a long hard look, and determine that (a) the financial statements as a whole and (b) the method of reflecting any major transaction (particularly those on which there may have been controversy), are fairly presented and not misleading.

In his address before the same annual meeting, the Chairman of the SEC, William J. Casey, discussed the Continental Vending case. His discussion can be interpreted as coming to a conclusion concerning the meaning of the case that differs from the conclusion presented in this paper. His discussion can be interpreted as indicating, approvingly, that the case means that auditors must apply their own private standards in appraising presentations as a whole:

> In Continental Vending, the court established that it is not enough to merely adhere to rules, even if they are generally accepted principles or standards. Rather a critical test is whether the financial statement, as a whole, fairly presents the position of the company and accurately reports its operation for the period it purports to cover.

A statement of John C. Burton, Chief Accountant of the SEC, also can be interpreted as saying that an auditor should apply his own private standard to the presentations as a whole. In a speech before the New York State Society of CPAs in December 1972 he said that it would not be prudent for the auditor "to say that in his opinion the statements were a satisfactory application of a formula. Because if he thinks that the statements are acceptable but not as he would have prepared them, then he'd better be careful before he puts his name on them."[19/] In an interview, James Needham, Chairman of the New York Stock Exchange, referred to Mr. Burton's words and said "I think Mr. Burton is right."[20/]

Business Week magazine, in an editorial in the February 10, 1973 issue, page 92, discussed the new code of professional ethics and recent court cases. Its discussion also can be interpreted as coming to conclusions concerning the meaning of the new code and court cases that differ from the conclusions presented in this paper. The editorial can be interpreted as saying that those developments mean that auditors must now go beyond GAAP to their

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19/ News Report, The Journal of Accountancy, February 1973, pp. 10, 12.

20/ News Feature, The Journal of Accountancy, March 1973, p. 29.

own private standards to appraise the presentations as a whole:

> [Rule 203 of the Restatement of the Code of Professional Ethics] rightly puts the burden on each accountant to look beyond "generally accepted accounting principles" to the overall fairness of financial statements—a position that the courts have taken.

Calls to enlarge responsibilities to appraise application of GAAP. Other observers are asking auditors to accept more responsibility, but within the framework of GAAP. Although the Chief Accountant of the SEC can be interpreted as asking in his December 1972 speech that auditors apply their own private standards completely apart from GAAP, in an Accounting Series Release he said that

> ...it is not an appropriate solution to have each company independently decide what the best measure of its performance should be and present that figure to its shareholders as Truth. This would result in many different concepts and numbers which could not be used meaningfully by investors to compare different candidates for their investment dollars.21/

The SEC recently asked auditors in connection with extraordinary or unusual items or provisions for loss—to decide whether GAAP have been "fairly applied." Accounting Series Release No. 138 requires

> A report from the registrant's independent accountants in which they state that they have read the description in the Form 8-K of the facts set forth therein and of the accounting principles applied and whether they believe that on the basis of the facts so set forth that such accounting principles are fairly applied in conformity with generally accepted accounting principles....22/

21/ Securities and Exchange Commission, Accounting Series Release No. 142, Reporting Cash Flow and Other Related Data, March 15, 1973, p. 2.

22/ Securities and Exchange Commission, Accounting Series Release No. 138, Notice of Adoption of Amendments to Forms 8-K...., January 12, 1973, pp. 3-4.

William J. Casey, Chairman of the SEC, in commenting on the collapse of the Penn Central Company suggested that auditors should decide whether the GAAP used are misleading in the aggregate although each specific principle perhaps is justified:

> 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.23/

The implication is that principles or judgments made in applying principles that are acceptable one by one may be unacceptable in combination. Appraising the combination of individually acceptable principles or judgments is a responsibility to appraise the application of GAAP beyond what is now generally considered required.

Others believe that if an auditor prefers an alternative principle to the principle actually used he should indicate his preference even though both principles are generally accepted. That responsibility is hinted at in an announcement of an FASB qualitative standards project: "The project is intended to develop 'moral and ethical' guidelines to govern choices when more than one accounting method is acceptable."24/

Summary of Developments. To summarize, the restated ethics code and the Continental Vending case both address the question of how far an auditor must go in appraising the application of GAAP in

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23/ Letter dated August 3, 1972 from William J. Casey, Chairman of the SEC transmitting the SEC "Staff Study of the Collapse of the Penn Central Company" to Representative Harley O. Staggers, Chairman, Special Subcommittee on Investigations, Committee on Interstate and Foreign Commerce, House of Representatives.

24/ The Wall Street Journal, April 5, 1973, p. 8.

particular circumstances. The statements of many of the leaders calling for enlarged responsibilities for individual auditors can be interpreted as addressing the same question. Some leaders, however, have made statements that can be interpreted as asking the individual auditor to apply his own private standard completely apart from GAAP in addition to applying the standard of GAAP.

Individual Responsibility Within a Professional Framework

In this section we offer our thoughts and recommendations on the responsibilities auditors should take.

Let's Not Undermine GAAP. The profession as a whole and authoritative bodies have the responsibility to establish the framework within which individual auditors should work. A professional framework is necessary to attain a universal level of quality at least up to a minimum standard. The professional framework, GAAP, should produce reliable financial statements that serve the needs of users of the statements. If the profession and authoritative bodies fail in that responsibility, everyone will suffer, including individual auditors, the profession, and the public.

Individual auditors should be responsible for working within the professional framework of GAAP. But although they should abide by GAAP, they should not be compelled to state that they personally approve of GAAP. An auditor should not be forced to state that he approves of something of which he does not approve. In the language of the APB Chairman, that would often force him to state a "flagrant lie."

Moreover, the auditor should not be required to form and express an opinion on financial statement presentations based on his own private standard completely apart from GAAP. The arguments for requiring the individual auditor to add an opinion of the presentations based on his own private standard completely apart from GAAP rest on the imperfections of the process by which GAAP is established. The process is necessarily subjective, is subject to compromise, and may result in lowest-common-denominator accounting. The argument is that the user is entitled to know what the auditor personally thinks about the presentation entirely apart from the views of his colleagues in his profession and of authoritative bodies.

But the arguments against requiring the separate opinion persuade us that the separate opinion should not be required. The most important counter argument is that the requirement would serve to undermine GAAP. Auditors would frequently be required to state their opinion that presentations conform with GAAP but are not fair, perhaps accompanied by treatises on accounting theory defending their view. GAAP would be constantly challenged publicly, resulting in a loss of confidence in GAAP as a standard. A severe loss of confidence could even provide impetus for abandonment of GAAP as a standard, thereby losing the benefits of comparability and a universal level of quality at least up to a minimum standard. Other arguments against requiring an opinion on fairness apart from GAAP are that (1) the great majority of auditors do not have a well formed opinion about presentations completely apart from GAAP, (2) members of a public accounting firm would find it difficult to agree on presentations completely apart from GAAP and sign reports in the name of the firm, and (3) unhealthy competition among firms would be engendered based on whose personal ideas on accounting theory agree with those of the client.

Individual auditors who disagree with GAAP should work to change GAAP but should not be required to publicize their disagreements in every report they sign.

Increased Responsibility Within GAAP. Within the professional framework of GAAP is a wide latitude for increased personal responsibility. Specific GAAP can only relate to individual financial statement items or specific disclosures. Only the individual auditor can appraise combinations of principles or appraise alternative principles. But those appraisals need not be based on his own private standard completely apart from GAAP. Their purpose is to determine whether the presentations as a whole conform with both the letter and spirit of GAAP.

The line between appraisals of presentations within GAAP and apart from GAAP should be carefully drawn. We suggest that auditors should vigorously resist calls to go beyond GAAP in those appraisals. But, we also suggest the adoption of a constructive attitude for more responsibility for appraisals of presentations within GAAP.

Studying Responsibilities in the Public Arena

The purpose of this report has been to indicate that determining independent auditors' responsibilities is prerequisite to clarifying the auditor's report and to put into perspective the questions that should be asked in examining those responsibilities. It contains our recommendation that enlarged responsibilities should remain within the context of GAAP but does not explore that question, which is a broad issue beyond the limited scope of a technical research report. The enlarged responsibilities should be studied in the public arena. A public hearing on auditors' responsibilities would help elicit viewpoints of members of the profession, of those who are served by the profession, and of those who regulate or influence the profession, and would help gain acceptance by all parties for conclusions reached. Once the responsibilities have been carefully determined and agreed on, the wording of the auditor's report can be fruitfully reexamined.

The search for language for the auditor's report should also be conducted openly. Suggestions should be elicited for language to describe the responsibilities agreed on. Empirical testing should establish that language chosen is clear and not ambiguous to informed laymen.

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