University of Mississippi

eGrove

Proceedings of the University of Kansas Symposium on Auditing Problems

Deloitte Collection

1972

Auditing looks ahead: Proceedings of the Touche Ross/University of Kansas Symposium on Auditing Problems

University of Kansas, School of Business

Howard Stettler

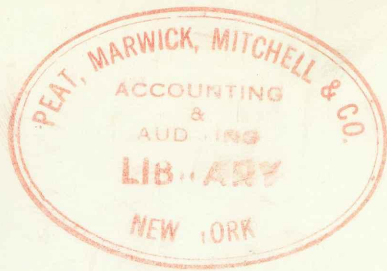
Follow this and additional works at: https://egrove.olemiss.edu/dl_proceedings

Part of the Accounting Commons

Recommended Citation

University of Kansas, School of Business and Stettler, Howard, "Auditing looks ahead: Proceedings of the Touche Ross/University of Kansas Symposium on Auditing Problems" (1972). *Proceedings of the University of Kansas Symposium on Auditing Problems*. 1.
https://egrove.olemiss.edu/dl_proceedings/1

This Conference Proceeding is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Proceedings of the University of Kansas Symposium on Auditing Problems by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.



auditing looks ahead

Proceedings of the
1972 Touche Ross
University of Kansas
Symposium on
Auditing Problems

HOWARD STETTLER, EDITOR

Auditing Looks Ahead

Proceedings of the 1972
Touche Ross/University of Kansas Symposium on
Auditing Problems

Edited by
Howard F. Stettler

May 11 and 12, 1972
School of Business
University of Kansas
Lawrence, Kansas 66044

These contents have not been copyrighted, and permission is hereby granted to reproduce or quote from material included herein in whole or in part, *provided* that full credit is given to 1) the author of the material and 2) this source: AUDITING LOOKS AHEAD; *Proceedings of the 1972 Touche Ross/University of Kansas Symposium on Auditing Problems.*

PRINTED BY THE
UNIVERSITY OF KANSAS PRINTING SERVICE

Additional copies may be ordered at a price of $4.00 from:

STUDENT UNION BOOKSTORE
University of Kansas
Lawrence, Kansas 66044

Preface

Two decades of overwhelming concern for the pressing problems of accounting principles have rather effectively obscured the fact that such concern is but a natural concomitant of the basic professional responsibility of auditing: adding credibility to financial information. In a very real sense, auditing is the parent and accounting principles but the child (and an adopted one at that!), whose needs and demands have grossly overshadowed those of the parent.

For the evidence that this is actually the state of affairs, one need but consider the spartan attention and support devoted to the Committee on Auditing Procedure in contrast to that lavished on the Financial Accounting Standards Board and its predecessors, the Accounting Principles Board and before that the Committee on Accounting Procedure. An obvious cause for this disparity is the fact that auditing standards are largely an internal matter, whereas the public interest and concern for accounting principles has placed the workers in that particular vineyard under time pressures to hurry the work along, while at the same time being forced to work in the constant glare of the public spotlight.

The original proposal to Touche Ross Foundation to sponsor a symposium on auditing problems was presented as a means to help restore some semblance of balance and proportion between auditing and accounting. The plan, reflected in the following pages, was to obtain a series of papers on matters of current concern in auditing, with a roughly equal distribution between practitioners and educators invited to prepare the papers. A member of the alternate group was then invited to serve as formal discussant of the paper, thereby leading into a general discussion of the paper by all who were present for the symposium.

More than forty persons participated in the symposium, again about equally divided between practitioners and educators, and with representatives included from the AICPA Committee on Auditing Procedure and the AAA Committee on Basic Auditing Concepts. The papers and discussants' remarks are arranged in these Proceedings in the order in which they were presented, with the exception that Marvin L. Stone's remarks in Chapter 8 were delivered at the dinner held at the close of the first day of the two-day event.

The papers and discussants' remarks generated lively but penetrating discussions, sometimes with practitioners and educators holding different views, but most frequently with relative agreement between the two groups that was perhaps unanticipated by many. There has been no attempt to summarize the discussions, but both the preparers of the papers and the formal discussants have had an opportunity to modify their papers and remarks as originally presented to reflect matters that arose during the discussion periods.

As chairman of the symposium, I take full responsibility for the selection of the topics for the invited papers, but the views expressed in the papers are those of the preparers, and, of course, not necessarily those of the organizations with which they are affiliated. Although there was no chosen theme for the symposium as a whole, it is of more than passing interest to note the frequency with which references to auditor independence occur throughout the papers.

The references generally involve questions of preserving and strengthening independence or of the influence of independence as a factor to be considered with respect to a given problem or decision. The fact that these references evolved naturally in the development of the various topics suggests the mature consideration that those associated with the auditing profession give to the unique obligation of independence that the profession has assumed.

The Touche Ross Foundation sponsorship of the symposium has likewise made possible the printing of this volume, thereby affording wider distribution to the significant ideas and views generated in the course of the symposium. I especially wish to acknowledge the unstinting efforts of Donald J. Bevis in helping to bring to fruition the proposal that such a symposium be held.

HOWARD F. STETTLER

June, 1972
University of Kansas
Lawrence

CONTENTS

Preface iii

1. Some Historical Auditing Milestones; An Epistemology of an Inexact Art
   R. GENE BROWN and ROGER H. SALQUIST 1
   Discussant's Response, HORACE G. BARDEN 12

2. What Are the Courts Saying to Auditors?
   A. A. SOMMER, JR. 23
   Discussant's Response, RUSSELL A. TAUSSIG 36

3. Toward Standards for Statistical Sampling
   KENNETH W. STRINGER 43
   Discussant's Response, JAMES W. KELLEY 50

4. Future Extensions of Audit Services; Meeting Investors' Future Needs
   DONALD J. BEVIS 55
   Discussant's Response, JOHN C. BURTON 67

5. Toward Standards for Materiality (?)
   WILLIAM HOLMES 71
   Discussant's Response, SAM M. WOOLSEY 79

6. Toward a Philosophy of Auditing
   R. K. MAUTZ 85
   Discussant's Response, HENRY P. HILL 96

7. Future Directions for Auditing Research
   DOUGLAS R. CARMICHAEL 101
   Discussant's Response, FREDERICK L. NEUMANN 112

8. The Problem with Auditing Is . . .
   (The Stuff Dreams Are Made Of)
   MARVIN L. STONE 121

1

Some Historical Auditing Milestones; An Epistemology of an Inexact Art

R. Gene Brown
Syntex Corporation (formerly of Stanford University)

and

Roger H. Salquist
Zoecon Corporation

To accept an assignment to write of history is in many ways more foolish than to attempt to be a soothsayer. When one forecasts, the reasonableness of his assertions can be debated but only substantiated by the passage of time, at which point one can blow the dust off the forecasts (if they proved reasonably accurate) and point with pride to such clairvoyance. If the forecasts missed the mark, one can let the earlier assertions rest forgotten unless reminded thereof, at which point a cloudy crystal ball can be argued to have been expected given the vagaries of such a changing, dynamic environment.

On the other hand, a cloudy crystal ball is difficult to explain when one examines events of years past, for there are records, memories, and earlier expressed opinions as to history. It is not possible to wait for the passage of time hoping to receive plaudits for reasonable assertions, or brick-bats, if observations are different than those subject to historical "verification" or at variance from those of the reader's perceptions.

The historian hopes to make his contribution in one of three ways. Of greatest reward is the uncovering of some new artifact or information which will not only add to the store of knowledge, but help in explaining some facet of our heritage which heretofore had remained unknown and as frustrating as a missing piece from a jigsaw puzzle. A lesser, but nonetheless satisfying endeavor, is to start with the known historical body of knowledge and successfully structure some new theory permitting a greater understanding of one's heritage or present behavior. Of least satisfaction is to attempt to order given knowledge in a fashion in which it has not previously been ordered, hoping to enhance the understanding of the past and permit greater perspective of today's moment in history, and hopefully, a better basis for speculations as to the future. It is this latter contribution that we hope to make in this paper, an epistemological approach, that is, the study of the nature and substance of audit history with the objective of better understanding the evolutionary process which shaped the present state of the art and may influence future occurrences.

Difficulties with an Epistemological Approach to Auditing History

Three identifiable steps must occur to successfully carry out an epistemological study: first, the important, influential events must be identified and segregated from trivial events. This first step is critical, yet difficult, for it is easy to make an error of commission and include some event which in others' judgment should not be considered, or to make an error of omission and fail to include in one's consideration some important influential factor of history.

The second step to perform is to order the identified important historical variables in some manner which can lead to the necessary third step, an interpretation of the events and their ordering. This second step is also difficult, for the historian is plagued with uncertainties as to the *cause* or *motivation* underlying the occurrence of a specific event, the actual *importance* of the event at the time it occurred, as well as the true *influence* of the event on the evolution of the art. It must also be recognized that the ordering process itself structures the analysis and interpretation of historical events. These difficulties are not unique to the study of auditing history, but plague the student of the history of any art or science. Certain other difficulties seem more uniquely associated with the study of auditing history, especially in viewing the so-called auditing "milestones."

We first encountered the milestone in France (*milleborne*), where it is used as in other principally European countries to mark orderly, measurable steps to a predetermined goal (mileage traveled from a given city and remaining to another specified city). It stretches our imagination to argue that there have been orderly and measurable happenstances in audit history which can be stated to have occurred with some specific goal in mind. Auditing evolution has been irregular, responding to pressures from within the profession and the environment, with no specific goal or goals which have been historically consistent or even well articulated, and with a distinct lack of specified hurdles against which progress can be measured. Perhaps this is understandable, since auditing is truly a service function, responding to demands for its service by adjusting its "theory" and tools of practice as needed to satisfy the changing needs of its customers. The service nature of auditing and the audit process are what encourage us to describe the practice of auditing as an "inexact art."

Art has been defined as a skill in performance acquired by experience, study, or observation. It is also defined in *Webster's Seventh New Collegiate Dictionary* as (a) an occupation requiring knowledge or skill, (b) a system of rules or methods of performing certain actions, and (c) systematic application of knowledge or skill in effecting a desired result. Certainly, these definitions describe the auditing process even though the auditor may use the scientific method of reasoning from an hypothesis and collecting and interpreting data in order to affirm, deny, or modify the hypothesis. The use of such a "scientific" tool as probability sampling does not change the fundamental nature of the auditing process; a process which cannot but be described as an art, and an inexact one, at that. This inexact nature of the audit process, the evolution of the art in response to internal and external influences, and the lack of a consistent and articulated set of goals, render difficult any epistemological study. Nonetheless, the major factors influencing audit evolution and the important

events that could be identified made possible some structure and ordering of auditing "milestones."

Choosing a Structure for Ordering Historical Audit Events

One possible approach, and the one which we first attempted, was to make an extensive review of the literature and prepare a chronological inventory of important events in the history of auditing. Since the purpose of this paper is to make some observations about the milestones in the development of the profession in the United States, and since earlier audit history is reasonably well chronicled, we began our survey with the literature which could be reasonably argued to be representative of, or contributory to, the profession in this country. Once completed, however, we found that a sequential inventory of important publications and events was less than satisfactory, not only because of the uncertainties arising from fears of possible errors of omission and commission, but because of the lack of any apparent order or logic to the listing. A second problem is that any such list ignores cause and effect relationship, tending to concentrate on the "effect" side of the equation, while the "cause" is the most interesting if one is seeking to rationalize the occurrence of events or to use history in a predictive fashion.

A more exciting approach to ordering audit history would be to focus on the giants of the profession and their contributions. This has partially been accomplished in the form of several publications devoted to the lives of both academicians and practitioners. It is much more interesting to study people than events, but such an approach can only result in a disjointed survey since many of the important factors which shaped the profession were unrelated to individuals, being of economic, social and technological origin.

An interesting "macro" approach is to attempt to identify the major socio-econo-technological environmental influences on the evolution of the auditing profession along with the identification of the response of the profession to those influences. Such an approach is quite a chore, for two reasons: first, cause and effect relationships such as these are difficult to establish in an *ex-poste* manner, especially when one realizes that these relationships were often not understood or documented at the time, much less decades later, and second, because there is not always a clear cause which can be associated within a given time period with an important event which occurred.

Another method of ordering historical milestones is through a characterization of the profession by looking at the major "eras" through which it passed in its development. Such an era classification is also difficult, since many events are not subject to placement into neat little boxes of time or character, in the sense that they are evolutionary in nature. A significant lead-lag problem also exists, since certain environmental influences do not make their presence known in the professional literature or practice until long after the cause for the evolutionary change has vanished or diminished in importance.

In reviewing the chronological inventory of events which we prepared, and in stepping back to reason therefrom, we decided that the last two approaches mentioned above would be most interesting and most useful in attempting to generalize about our professional heritage. The next two sections of the paper present these two orderings of auditing milestones, with the era classification

provided first and the socio-econo-technological environmental (in a cause and effect relationship) presented second. In a sense, this provides two different ways of viewing the same history. Since any ordering is a matter of choice, the use of two alternative methods of classification permits us to test how important the choice itself is in making generalizations of relevance as to the current status of the profession and/or assertions as to the future.

Auditing Milestones Classified by Era

Since we are dealing with the epistemology of a profession, it makes sense to view its evolution in terms of the major periods of professional change or growth. We have selected the following five classifications as being a useful description of the eras of auditing evolution: "Emergence," "Consolidation," "Technology," "Professionalism," and "Conflict and Uncertainty."

The various eras can be described generally as follows:

Emergence	The birth and early development of the auditing profession in the United States.
Consolidation	The move toward combination, uniformity and strength.
Technology	The interest in and sometimes preoccupation with audit tools and techniques, especially the so-called "scientific" tools.
Professionalism	The assumption of responsibility for shaping the destiny of the profession rather than responding to outside pressures for change; organizing and bonding together for influence.
Conflict and Uncertainty	Serious questions about the nature and scope of audit content and responsibility create internal conflict within the profession.

The specific important audit milestones which we would attribute to each of the five eras which we isolated are shown in the table following.

AUDIT MILESTONES CLASSIFIED BY ERA

Era	Audit Milestones
Emergence: Late 19th Century to 1920	• The expansion of business enterprises and the great influx of foreign capital into the United States in the late 1800's created the need for a body of trained accountants. • The American Association of Public Accountants was formed in 1887. • The State of New York passed the first public accounting law in the United States in 1896. • Mounting credit problems in the early 1900's caused bankers to pressure corporations to have their balance sheets "certified." • The literature of auditing began to mature. *The Journal of Accountancy* commenced publication in 1905. In 1914 Robert Montgomery published the first United States auditing textbook, an adaptation of Dicksee's 1892 English text. • In 1916 the American Association of Public Accountants was re-organized and became the American Institute of Accountants. The change reflected the movement of the

Era	Audit Milestones
	profession from a very regionalized apparatus to a truly national organization, promoting uniform goals and standards. • The adoption of the Corporate Income Tax in 1917-1918 caused the demand for accountants' services to soar. • The growth of external pressures caused by the growing number of business failures and the extreme lack of uniformity of financial statements led to the publication of "Uniform Accounting: A Tentative Proposal Submitted by the Federal Reserve Board" in 1917.
Consolidation: 1929 to Early 1940's	• In 1929 a special committee of the AIA undertook a major revision of the 1917 Federal Reserve Board audit guidelines to reflect the growing importance of profit and loss statements, include evaluation of internal control as an integral part of the audit, and remove many of the inconsistencies in recommended audit procedure. • Public reaction to the stock market crash and the depression led to expanded governmental and other regulatory control over securities transactions and financial reporting. The SEC became a powerful entity with the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. The New York Stock Exchange required audits for all listed companies in 1933. • In 1930 the AIA appointed the first committee on cooperation with the stock exchange. • In 1931 the *Ultramares* case established the limited liability of auditors to third parties not "in privity." • The McKesson-Robbins scandal in 1939 revealed the inadequacies of accepted methods of auditing inventories and receivables, and led to the formation of the special AIA committee on auditing procedure, which published "Extensions of Auditing Procedure" in May of that year. The committee was made a standing committee, and it soon commenced regular promulgation of the "Statements on Auditing Procedure."
Technology: 1950's	• This era was primarily occupied with the development of more sophisticated tools by which the audit process could be improved: —The introduction of computers and the steady conversion of business data management to Electronic Data Processing modes led to the development of specialized methods for auditing the computer and using the computer to increase audit efficiency. —The refinement of statistical techniques led to increasing usage of statistical sampling. —Formal, quantitative evaluation of internal control was proposed as a means of determining the extent of detailed testing that was required. • The recognition of the applicability of the specialized abilities of accounting professionals to all areas of business management led to the emergence of management services.

Era	Audit Milestones
	• The Committee on Auditing Procedure continued to gain influence by further clarifying the auditor's responsibilities and the scope of his examination.
Professionalism: 1960's	• The profession assumed increasing responsibility for shaping its own destiny by interacting with external professional and regulatory agencies in attempting to improve the uniformity and information potential of "generally accepted accounting principles." • The Accounting Principles Board emerged as a powerful policy body. • The concepts of management auditing were developed. • The techniques of analytic review and of continuous auditing were refined and put to increased use.
Conflict and Uncertainty: 1970's	• Public criticism of accounting principles and of the limited extent of disclosure in certain instances is made effective through class action suits and stockholder pressure for expanded board representation and greater public disclosure. • The judicial concepts of legal liability expand and the auditor's responsibility for fraud and deception becomes cloudy. • The further development, standardization, and uniformity of techniques leads to questions re: "professionalism," in the sense that professionalism equals the ability to set one's own parameters for audit plans, procedures, and tests. • Increased interest in the issuance of financial forecasts and the growing importance of interim reports raise questions about the need to assure the accuracy of those reports, thereby creating new responsibilities for the profession. • The need to develop new audit techniques arises as the trend toward reporting current values develops.

Socio-Econo-Technological Influences on Auditing Evolution

Generalization of development by era is less than a totally satisfactory approach to history since it tends to obscure important cause-effect relationships. We can identify important events but we cannot say why the events occurred or measure their relative significance. By identifying the relevant social, economic and technological movements that have occurred during the last century it is possible to hypothesize a cause-effect relationship for these past developments and to improve our acumen at predicting future developments.

The Industrial Revolution. Certainly a dominant socio-economic movement in the last 200 years was the industrial revolution. The discovery of various means to create and harness mechanical power and the recognition of efficiencies possible from specialization of labor and consolidation of effort led to the modern industrial state. The revolution resulted in successively larger corporate entities and increasingly complex organizational structural forms, culminating in the existence of multi-national giants such as General Motors and

ITT, whose annual sales exceed the gross national product of all but a few of the larger nations of the world.

The aspect of the industrial revolution which had the greatest impact on the accounting profession was the growth in size of the business entity. Expanding corporations relied heavily on external credit, creating a vital need for expert independent professional attestation as to their financial condition. Expanding size meant also that all operations could not be under the direct control of a single manager, creating the need for a system of internal controls. Professional review of the adequacy of the controls fell to the independent auditor. Finally, as growth in size continued, the practical bounds of detailed checking were reached, and sampling procedures became the only realistic method of audit examination. The very genesis of the auditing profession and the source of two of the major audit "tools" (review of internal control and sampling) can be traced to the industrial revolution.

Public Ownership. A major consequence of the growth in size of companies was widespread public ownership of corporations. Expanding public investment in business in the early 1900's resulted in the separation of ownership and management and created the need for means of measuring the stewardship of management and providing large numbers of potential investors with information upon which investment decisions could be rationally based. The lack of uniformity and consistency in reporting methods and the need for independent certification of management's representations became a pressing issue as the large base of investors sought to evaluate the information being presented to them.

This new public voice and the persistent supplications of bankers caused increasing numbers of corporations to elect auditors and to have their statements certified in the years prior to 1929. However, there was little uniform agreement on just what audit objectives and procedures were or just what was being certified in a "certified statement." Many corporations simply stated that their records had been examined by certain auditors and neglected to mention the results of that examination. The efforts of the profession to develop uniform standards for reporting and for audit examination were drowned in the euphoria of investor speculation.

Regulatory Influence. The crash of 1929 brought into sharp focus the reporting abuses that had existed all along, but which had been tolerated or ignored. The influence of the stock exchanges, the emergence of the SEC and other regulatory agencies, and pressure from the investing public, encouraged the accounting profession to work in earnest to codify and enforce uniform rules of financial reporting and audit examination.

The Securities Act of 1933 and the Securities Exchange Act of 1934 are, of course, the foundation of the legislative structure that has been erected to establish the basic requirements of standardization of disclosure and mandatory audits. The SEC has steadily widened the extent of regulation through the periodic issuance of Accounting Series Releases, SEC Regulations, and the opinions of the Chief Accountant. The stock exchanges have amended their regulations to specify more rigorous requirements, and the courts have consistently expanded the scope and applicability of the original regulations. Thus, today's growing public pressure for more disclosure and greater uniformity in financial reporting is all the more effective because of this broader range of "tools" at its disposal.

Legal Environment. It was in the aftermath of the depression that the broader judicial view of individual and professional liability, which is continuing to develop, had its roots. The courts assumed a progressively more activist role toward all phases of society; they also reoriented their posture toward the business world from an attitude of "caveat emptor" to one of staunch defense of the rights of the public consumer of products and financial information. The courts progressively translated the ethical considerations of the past into the legal duties of today.

The reasons for this shift in judicial perspective can be traced in part to the increasing power and remoteness of business vis-a-vis private investors, and the desire to place the responsibility for the consequences of unfavorable events upon those who have the authority and ability to directly influence the events.

The impact of this judicial evolution has, of course, been a drastically expanded definition of the common-law liability of public accountants for injury to third parties. The concepts of limited liability established by Justice Cardozo in the Ultramares case in 1931 have been steadily broadened until the doctrines of privity, foreseeability and *scienter* were obscured. The BarChris decision in 1968 established the liability of auditors to third parties not "in privity" and the Continental Vending case (U.S. vs. Simon, 1969) punctured the shield of "generally accepted accounting principles" by requiring adherence to higher standards of fair presentation and informativeness.

Not only have the courts expanded the common law liability of accountants, but they have broadened and more rigorously enforced the existing regulations of the SEC and the stock exchanges. Of greatest impact have been the cases decided under SEC Rule 10b-5, which was originally intended to protect against fraud in the purchase as well as the sale of securities. Accountants' liability under this regulation was broadened by Fisher vs. Kelty in 1967, where defenses of "absence of privity" and "lack of personal gain" were overruled and a requirement for more complete disclosure was established. The Texas Gulf case, also prosecuted under Rule 10b-5, expanded the spectre of liability by establishing that evidence of "wrongful purpose" was not a requirement of a 10b-5 violation.

The impact of this legal onslaught upon the sanctity of the auditor has been reflected in standardization and codification of audit procedures. Two cases in point were the promulgation of "Extensions of Auditing Procedures," which established the requirements for more rigorous receivables and inventories testing in 1939 following the McKesson-Robbins case, and the adoption of Statement on Auditing Procedure Number 41 which detailed the accountant's responsibility to report the discovery of facts subsequent to the completion of the audit, as the direct result of the Fisher vs. Kelty decision.

Broader Social Changes. One can reasonably hypothesize that the legal trend described above is merely a reflection of the broader shift in the attitudes of society as a whole. One impact of an affluent society is to see a subordination of the drives for basic needs to the drives for love, acceptance, and self-actualization. The business world has lost its "mystique" and more and more people are concerned with the quality of life versus the quantity of goods, with the social cost of public goods, and with the social responsibility of business. Certainly the greater awareness and higher educational levels of the public have created

the demand for disclosure of matters previously considered to be privileged information and for greater professional responsibility.

One aspect of this greater social and public awareness is reflected in the accounting profession's desires to improve the quality of the financial representations produced for the public as well as the underlying audit support of that product. Liaison committees with the stock exchanges, the SEC and other regulatory agencies have been re-emphasized. The APB was formed to establish an authoritative professional doctrine that would serve to clarify and standardize corporate financial reporting so as to make it more meaningful for the public and more relevant for investment decision making. This increasing degree of professionalism (the assumption of responsibility for shaping one's own destiny and for responding to social needs) has been characteristic of the accounting profession recently.

Technological Change. Though the socio-economic trends have been the prime determinants of audit development, there is one technological influence that cannot be overlooked. The development of computers has drastically altered methods for data manipulation and allowed accomplishment of tasks of a magnitude previously unimagined, as well as accomplishment of routine tasks of previously infinite duration in a relatively short period of time. Since Univac I was introduced in 1951 we have progressed through three generations of computer sophistication and reached the stage where business simply cannot function without computer processing.

The transfer of much of business accounting data manipulation to computers may have improved the accuracy and speed of performance of simple clerical tasks, but it has added another dimension of the internal control problem: the computer programmer/operator complex; and it has in many cases made the audit trail much more difficult to follow. These factors have caused auditors to accelerate the development of corroborative and generalized evaluative techniques of auditing. The development of and increased reliance upon analytic review, statistical sampling, quantitative internal control evaluation, and comprehensive overall audit systems have been greatly accelerated by the computerization of business.

Summary

Our attempts to develop some reasonable structure for viewing audit milestones have tended to reinforce the assertions made earlier in the paper about the lack of orderly development of the profession. Auditing has not been characterized by a systematic and orderly development. It has not progressed down a well-defined path toward some predetermined goal. It has not, until recently, taken a strong professional responsibility for shaping change rather than responding to change. Much of the progress which can be identified has resulted from strong environmental influences, not the least of which has been the evolving regulatory and legal climate.

Unfortunately, many of these observations of the past seem to be still with us when assertions as to the future are made. Perhaps, due to the service nature of auditing, one cannot but expect a somewhat chaotic development, since the demand for and nature of work to be done is itself chaotic. Certain highly probable events on the horizon will tend to be professionally disruptive should

they occur. Three of the most prominent of these are (1) the trend toward "current value" measurements in financial reporting, (2) steps being taken toward increased publication of financial forecasts, and (3) increasing internal and external questioning of the scope and nature of traditional audit field work.

Current value reporting, in the sense of reporting valuations based upon existing market prices, replacement costs, or net realizable values, presents unique auditing problems of verifiability and testing. To the extent that many members of the accounting profession and investment community are advocating using current values for financial reporting, and to the extent that some progress has already been made in this direction, the auditing profession will face new requirements in planning and implementing the attest process.

With regard to publishing financial forecasts, a great deal of study is taking place within the professional societies in the accounting and financial communities, and many individuals are advocating formalization of such reporting. The SEC has already held hearings on publishing forecasts, and forecasts are now published in a variety of ways in the United States. In Great Britain and Holland financial forecasts are required to be published in some circumstances and certain audit responsibilities have been defined with respect to these forecasts. This attest responsibility has thus far been limited to an expression of an opinion with respect to whether or not the forecasts are consistent with the underlying assumptions used by management (and published with the forecasts) in making the forecasts themselves. Even if audit responsibility were so limited in the United States, new questions of liability and audit relationships between the various parties at interest would arise. In fact, it seems that tremendous conflict could occur if the auditor found that the rather mechanical forecasting calculations were in fact in accordance with the underlying assumptions, but that one or more of the assumptions themselves were questionable or fallacious.

A more subtle, and debatable, difficulty which we foresee arises more from a feeling and from conversations than from a discernible trend in the literature or in professional meetings. It seems to us that there is little basis for believing that the rather extensive audit testing that still occurs (even though the amount of detailed testing has been reduced) is justified when one looks at the types of difficulties which require a qualified opinion, a disclaimer, or extensive conversation between auditor and client prior to issuance of a clean opinion. Most reporting issues are exactly that, *issues*, arising from a measurement choice made by management from the alternative reporting possibilities available to them. In fact, most of these issues are known to both client and auditor and are not disclosed by "testing," in the usual sense. Other than for establishing precise cutoffs, audit testing tends to be defensive, wherein many tests performed cannot possibly lead to evidence that would cause the auditor to alter his opinion; indeed, many of the tests are apt to disclose internal control weaknesses or routine processing errors of concern to the management of a company but not to the shareholders. A possible exception would be disclosure of fraudulent transactions or events, where it is officially argued that the normal audit is not designed to, nor can it be relied upon, to disclose defalcations that do not materially affect the financial statements. As clients, outside investors, and auditors themselves push for higher quality work and better financial reporting, we feel that the entire audit process will be re-thought, including audit objectives and techniques.

Despite the rather critical evaluation which we have made of the manner in which audit progress has taken place, and the causation for that progress, we do have confidence that the profession will become an ever more constructive influence in the broad arena of financial reporting. However, such progress will not come in as orderly a manner as one would like, nor will the profession achieve its potential until it assumes an even more aggressive posture toward structuring its environment and itself, and until it does a more rigorous job of defining its goals and mapping the road to travel to attain those goals, including the measurable milestones.

Discussant's Response to Some Historical Auditing Milestones; An Epistemology of an Inexact Art

Horace G. Barden
Ernst & Ernst, Retired

My initial invitation to participate in this symposium asked if I would undertake to discuss a paper entitled, "Some Historical Auditing Milestones—How They Got There, What They Portend for the Future." (The authors of the paper subsequently proposed the revised title as it appears herein.) I wondered somewhat about how they happened to extend the invitation to me. I finally concluded they must believe that I am one of the few old practitioners still tottering around who was actually on hand as the profession encountered many of the events in the last forty-five years that are now considered milestones. The organizers of the symposium probably figured that if I had been there at the time these events occurred, I should at least be able to pass on the first part of the question, namely, "How They Got There," and if so, they would take a chance on my viewpoint when it came to distilling what the events portend for the future.

My active interest in accounting began in 1924, and it has been my principal interest since 1927. Accordingly, I was on hand and watching most of the events that Gene Brown and Roger Salquist have listed as historical auditing milestones. I think I can answer some of their questions as to whether they have omitted any important events. I should also be able to clear up some of their uncertainties as to causes underlying certain of the milestone events, their importance at the time, and the resultant influences on the profession.

I don't believe the combined efforts of the authors and myself are going to uncover any hitherto unknown facet of our heritage, or structure any new theory leading to a greater understanding of our present state of affairs. I do believe that our combined efforts might enhance understanding of the past, and give a wider perspective of today's moment in auditing history.

The Problem

I really doubt that I would have undertaken the authors' task by attempting the route of "an epistemological study." I shall admit that I quietly stalked that word "epistemology" for two or three days after my initial shock of finding it in the subtitle of their paper. I finally got up the courage to sneak into the library and pounce on it in an unabridged dictionary. According to the knowledge so recently obtained, I shall attempt to keep my discussion of their paper within a framework of interpreting the milestones in terms of the knowledge to be gained therefrom, its limits, and its validity.

I turn first to the question of whether we are, in fact, dealing with an inexact

art, irregular in its evolution, without articulated goals, but developed principally within a framework of pressures from within and from its external environment. I believe there is little argument about the notion that auditing is an art in the sense that it involves the systematic application of knowledge in performing certain actions to accomplish a desired result. It is definitely a service function, performed for business enterprises, with its indirect benefits flowing to management and other users of financial reporting. Like accounting itself, it is pragmatic in nature and its evolution has been shaped and modified to meet the needs of the various interests which it serves. Auditing theory has not been developed from a precise set of postulates which have been tested conceptually to deduce principles.

Drawing generalizations from detailed observations is inherent in the methodology of auditing. The same is true of the manner in which most theory of auditing has been established. This process has, nevertheless, developed a rather rigorous applied discipline, with a reasonably good organization of its underlying knowledge. Because of the pragmatic nature of auditing, its evolution has obviously taken place without very many specifically articulated goals which can be identified by milestones of planned accomplishments. Instead, we might better look at the historical events in its evolution as *landmarks*, from which new courses have been plotted in the development of auditing.

Auditing Theory and Practice vs. Accounting Principles

Some of the real milestones and landmarks in auditing history have been obscured somewhat because many people fail to distinguish auditing theory and practice from the development of accounting principles. The accounting profession has carried the primary responsibility for the latter for many years. It has found its attempts to develop authoritative pronouncements on accounting principles fraught with many pitfalls and with much unfavorable criticism from many directions. This has overshadowed much of the steady development of sound auditing theory and practice which has been taking place on a truly professional basis. I hope my discussion of the Brown-Salquist paper will demonstrate this more clearly. Much of the development has taken place quietly and discreetly within the profession in the same type of atmosphere in which the auditor exercises judgments in the confidential work required in carrying on his services.

The Ordering of the Events

The authors state they are fearful of committing errors of commission or omission by basing their observations on a sequential inventory of important publications and events which seems to them to lack order and logic. I can see how this approach might seem tenuous without some first-hand knowledge of the cause and effect relationships which would help rationalize the occurrence of the events.

In the final analysis, they select two approaches to their study of events, the "era" ordering of events, and the "macro" approach of ordering things in terms of the "major socio-econo-technological environmental influences." The two methods are used to test the validity of their selections to some extent. Reviewing these two orderings, I find myself relating more closely to the "macro" ap-

proach. I have some difficulty with their classification of audit history milestones by eras, as to the timing and the descriptions of some of the eras.

I shall comment on the milestones selected under both means of ordering which the authors use, but I find it easier to take them up in about the order of time in which I observed them. I think that most of the milestone events were well understood as to cause and effect relationships by leaders in the profession at the time they occurred, even though the documentation of their understandings appears principally in the form of internal professional development rather than in published writings. I find that I need very little hypothesizing to recognize a few clear-cut landmarks that have had continuing monumental effects on the development of the profession.

The Industrial Revolution and Expansion of Public Ownership of Business

Auditing was a matter of relatively little concern until the time of the industrial expansion that occurred in the nineteenth century. Auditing for internal purposes might have expanded somewhat as business enterprises grew in size so as to assure management of proper accountability for liquid assets and the adequacy of internal controls, but the significant effect of the industrial revolution was the expanding public ownership of business enterprises which began in the early 1900's. This, combined with the expanding use of credit, brought about the concept of general financial reporting as the essential route through which to monitor the stewardship of management. These developments caused the auditor to expand his primary objective from that of providing assurances on internal accounting controls, to that of monitoring management's external reportings for the benefit of creditors, shareholders, and other outside users of financial information.

The environmental influences of the period of expanding size of business enterprises and public ownership induced what was truly an era of emergence, as the authors have designated in their ordering of the milestones by era. The growth and recognition of the auditing profession during this period was not particularly exciting. Historical milestones such as the first CPA laws, formations of professional accounting organizations, and the early attempts to formulate authoritative pronouncements on general financial reporting and auditing, all reflect orderly progress in meeting the need of the financial community of that time. The advent of income taxation added to the professional stature of the auditor. His knowledge of income taxation was necessary for auditing company liabilities, and his knowledge about the determination of income as the basis for the new tax naturally caused his clients to turn to him for his professional advice in this area. The authors might have noted this event as the beginning of a fifty year controversy between the budding accounting profession and the legal profession. The history of that controversy, incidentally, is replete with evidence of just how persevering accountants can be when they set their mind to achieving well-articulated goals.

I find it difficult to obtain much of a reading prior to 1929 on the "new public voice" of the "large base of investors" whose supplications, together with those of corporate creditors, were causing increasing numbers of corporations to elect auditors. It seems to me that the Accounting Objectives Study Group, which was formed by the American Institute of Certified Public Accountants

some forty years later, is still seeking to get readings on that same old public voice of the large base of public shareholders.

The State of the Art at the 1929 Crash

I would extend the era of emergence through 1929. The crash of the whole economy certainly was the landmark ending the first period of expanding public ownership in business. As to the state of the auditing art, I find a pretty clear picture in the booklet "Verification of Financial Statements" published in May of 1929, some six months before the crash. (As an aside, the booklet was available for 10¢ per copy.) This booklet was the American Institute's revision of the original publication by the Federal Reserve Board in 1917. The sub-title described the booklet as a method of procedure for the consideration of bankers, merchants, manufacturers, auditors, and accountants. The booklet contained some twenty pages describing the audit procedures considered appropriate at the time for "verification of assets and liabilities at a given date, verification of the profit and loss account for the period under review, and (incidentally) an examination of the accounting system for the purpose of ascertaining the effectiveness of internal check." The booklet concluded that, "If the auditor is convinced that his examination has been adequate and in conformity with these general instructions, that the balance sheet and profit and loss statement are correct, and that any minor qualifications are stated, he may issue a certificate," to the effect that he has examined the statements and that he certifies that in his opinion they set forth the financial position and results of operations. The audit instructions are evidence that a considerable amount of detailed checking was considered necessary at that time, but that it was not mandatory to confirm receivables and have contact with physical inventory-taking.

Many of the large firms still hired "temporary help" for their "busy seasons" in order to handle the large volume of detailed auditing work being done at that time. The rank and file of their staff organizations contained relatively limited numbers of university graduates. About twenty universities in the United States offered courses for a major in accounting, and there was considerable difference of opinion between professional accountants and the academic field as to what the content of the courses should be.

Beginning of a New Era: Foundations of Modern Auditing Concepts

Brown and Salquist set 1929 as the beginning of an era of "consolidation" which lasted through the early 1940's. They mention the public reaction to the stock market crash as bringing on the federal regulation of securities beginning in 1932-1933, and the Ultramares decision as two outstanding milestones in both their era and their macro approaches to auditing history. Considerably later, under their listing of broad social changes influencing the evolution of auditing, the authors classify the formation of the APB as evidence of the profession's increasing assumption of responsibility for the shaping of their own destinies and responding to social needs.

I combine the state of the art in 1929 with Ultramares and the SEC to place a different interpretation on the importance of these events and the extent of their influence on the profession. These events combined to cause the develop-

ment of modern concepts of auditing and the profession's initial assumption of responsibility for shaping its own destinies, all back in those troubled days of the 1930's. Within the framework of this new era of professional development, I can see several landmarks that I believe should be given greater recognition than that accorded by the authors.

A Theoretical Base for Auditing. The need for improved general financial reporting which was highlighted by the 1929 crash of the securities markets and the deep economic depression which it triggered, gave rise to the beginning of cooperative efforts between the accounting profession, as represented by the then American Institute of Accountants, the investment community, as represented by the stock exchanges, and industry, as represented by the Controllers Institute. These groups were later joined by representatives of the newly-organized Securities and Exchange Commission. Agreements reached in a series of correspondence between the New York Stock Exchange and the AIA during the period of 1932 through 1934, gave birth to the first generally accepted concepts of accounting principles and auditing theory. These concepts were embodied in the agreed form of short-form auditor's report which is used today with very much the same substance.

The theoretical base for auditing as we see it today is reflected in these features of the short-form auditor's report:

1. Financial statements are basic representations of management, and management has primary responsibility for them and for maintaining an adequate system of internal controls.
2. There is a body of generally accepted accounting principles which, if applied consistently, produces accounting information from which to prepare financial reports fairly presenting financial positions and results of operations.
3. The auditor operates in an environment of examining management's financial statements and rendering his professional opinion thereon, after carrying out such auditing procedures as he considers necessary and in conformance with generally accepted standards of performance.

These basic concepts of financial reporting and auditing were agreed upon in 1934, as a *foundation* for improvement in the format and quality of general financial reporting even though the agreements reached at that time did not attempt to document the generally accepted accounting principles and the generally accepted auditing standards.

I believe that *this* landmark of the middle 1930's was the point at which the profession really accepted the full responsibility for shaping its own destinies. The Chief Accountant of the SEC had been issued an order by the Commission at that point to establish the meaning of the term, "generally accepted accounting principles," and to issue an authoritative pronouncement on them. He had received the Commission's approval, however, to withhold any such action on his part, with the understanding that the AIA would set up the needed machinery to proceed with the issuance of authoritative pronouncements on both generally accepted accounting principles and generally accepted auditing standards.

The Institute did begin work on these two projects through its Committee on Accounting Procedure. Progress was slow and many of the proposals for developing accounting principles and auditing standards met with delays and

controversial actions by the Institute's governing body and its membership. Little had been accomplished when, late in 1938, the infamous McKesson & Robbins case came to light. The entire financial community, and particularly the stock exchanges and SEC were shocked to realize that, in almost ten years since the 1929 crash, relatively little progress had been made in improving the reliability of financial reporting. The immediate action prompted by this event was the Institute membership's approval in 1939, of "Extensions of Auditing Procedure," which made mandatory the confirmations of receivables and physical contact with inventory-taking.

Restructuring the Accounting Profession

Brown and Salquist recognize the McKesson & Robbins milestone in their "consolidation era," and in their listing of regulatory and legal influences on auditing evolution. I accord a great deal more significance to the event. To me, it was the beginning of an era of consolidation for the profession rather than the end. It could be designated better as the end of a period of "conflict and uncertainty" rather than designating that era as beginning in the 1970's as the authors do. I consider the lasting consequences of the McKesson & Robbins landmark to include the restructuring of the profession and the laying of the groundwork for the extensive internal educational and professional development programs of the Institute.

Separating the Development of Auditing Standards from the Establishment of Accounting Principles. The real shock of McKesson & Robbins to the leadership of the Institute was the realization that if they were really going to shape their own destinies, they would have to restructure the organization to overcome the cumbersome procedures which had caused them to bog down in attempting to carry out responsibilities they had undertaken some five years earlier. The result was a revision in their charter to enable establishment of "senior technical committees" which could speak authoritatively for the Institute without going through the lengthy processes of approvals by its governing body and membership. The Committee on Auditing Procedure was formed to deal with matters relating to auditing standards and procedures. The Committee on Accounting Procedure was designated to deal with accounting principles and their implementation. They were each charged initially with the respective responsibilities to develop authoritative pronouncements on auditing standards and generally accepted accounting principles.

You are all familiar with how the Committee on Accounting Procedure has fared since that time, eventually being replaced by the expanded concept of the Accounting Principles Board in 1959, and now about to be replaced with a new entity which is expected to relieve the Institute of some of the basic responsibility for the development of principles which they accepted, somewhat by default, in the 1930's. As I noted earlier in these comments, the attention that has been focussed on the difficulties of establishing principles has overshadowed a great deal of the progress that has been made in the field of auditing. The formation of the APB is designated by Brown and Salquist as a milestone in their era of professionalism and in meeting some of the broader social challenges of the times. The event really has had very little cause and effect relationship on the profession's auditing standards or procedures.

The restructuring of the early 1940's went beyond acceptance for developing auditing standards and accounting principles. The foundations were laid at that time for expanding the recognition of three basic functional areas in which accountants render professional service: auditing, tax consultation, and management advisory services. The Institute began formulating goals toward refining its organization so as to expand its services to members and to the profession generally in areas of, (1) examining and qualifying those seeking to enter the profession, (2) furnishing continuing educational and professional development programs in all three branches of accounting services, and (3) improving the quality of professional services by maintaining an appropriate code of ethics governing the professional behavior of its members. These are the hallmarks that have come to distinguish accounting as a profession rather than as a trade or an art.

Auditing Standards. World War II slowed progress, but the first big payoff of the restructured Institute's programs went on display in 1948 with the publishing of the tentative statement, "Generally Accepted Auditing Standards, Their Significance and Scope." I class this as a monumental milestone—marking the achievement of a carefully planned goal. It is a true landmark in auditing history in the sense that it provides a point from which to guide the course of action for those engaged in the most professional of the services rendered by professional accountants.

Perhaps I am more impressed by this event than many others because I was there and witnessed it. The initial exposure of this important document took place at the Institute's annual meeting in 1947. At a technical session presided over by Paul Grady, the then chairman of the Committee on Auditing Procedure, three committee members, Edward Kracke, Alvin Jennings, and John Lindquist presented, respectively, the general or personal standards of the auditor, the standards of field work, and the standards of reporting. To this day, I still consider that afternoon session as one of the most impressive technical presentations I have ever witnessed.

The Committee on Auditing Procedure restudied this document in 1954, for the purpose of adding one reporting standard to require the auditor to provide a clear-cut indication of the character of his examination and the degree of responsibility he is taking whenever his name is associated with financial statements. Hardly another word was changed except to take the term "tentative" out of the title. Practically the identical wording of the standards was carried over into the codification of auditing standards and procedures—issued as Statement on Auditing Procedure 33, in 1963.

Thus, I view the consequences of those milestone events of the late 1930's and early 1940's as providing the financial community today with a set of standards for measuring the quality of the professional auditing services upon which it relies. These same standards provide the auditor with a gospel by which to measure and challenge the truthfulness of his statement on the scope of his examination and his resulting opinion on the financial statements.

In addition to a continuing monitoring of performance standards and their adequacy, the Committee on Auditing Procedure has issued some fifty statements on auditing procedure, to provide guidance in new techniques required

by current developments in accounting and auditing. They have issued numerous booklets on special auditing problems of particular industries.

Educational and Professional Development Programs

Brown and Salquist find it difficult in searching for an ordering of historical milestones, to identify any part of auditing evolution as having resulted from the establishment of articulated goals against which to measure progress. I have very little difficulty in this respect. I can find the goals and the orderly progress not only in the development of auditing standards, but even more evident in the area of education and professional development of the auditor.

The outstanding milestone and landmark events in this area also go back to the restructuring that took place in the early 1940's, when the Institute began shaping its own destinies. Concentrating on the problems of developing an acceptable set of standards with which to measure the training and proficiency of the auditor focussed attention on educational requirements and professional developments.

The milestones that do exist as measuring progress in reaching the goals of well articulated programs have been recognized by many within the profession, but not particularly so by those outside. For example, a truly significant milestone occurred in the early 1950's when the goal was reached of having every state CPA law implemented through the Institute's uniform CPA examination. Today, the same examination is not only used in all fifty states, but all are accorded the Institute's uniform grading services. No other recognized profession can equal this degree of control over its admittance requirements.

Educational developments within the profession in the last twenty years have been sensational. Last year, over 10,000 accountants attended some twenty-five basic training programs, workshops, and courses in special accounting and tax subjects that were offered by the Institute in conjunction with state CPA associations. More than 15,000 accountants attended forty seminars and lecture programs on specialized subjects. Many state CPA associations offer additional programs. Most of the larger firms operate extensive in-house training and professional development programs. On the basis of my own firm's recent experience, I estimate roughly that partners and staff employees of the so-called big eight firms are currently spending in excess of 2,000,000 hours annually in attendance at in-house educational programs, and at least that amount in advance preparation and study for these programs. Several larger firms operate separate school facilities to conduct these training programs. Two states have adopted compulsory continuing educational requirements for maintaining a right to engage in practice as a CPA from year to year, and the Institute Council has recommended adoption of such requirements.

Another milestone in the profession's educational development programs is the publication in 1967 of *Horizons for a Profession*, by Robert H. Roy, and James H. MacNeill. This publication culminated an extensive study by a distinguished commission under the sponsorship of the Carnegie Foundation and the Institute, with an objective of delineating the common body of knowledge which should be possessed by those about to begin careers as CPAs. This study will have continuing effects on refining and coordinating the academic and professional training of future programs.

The Legal Environment

The following session of this symposium will discuss the subject of what the courts are saying to professional accountants in recent cases. The Brown-Salquist paper mentions the milestone cases which have had significant effects on the auditing environment. These are matters of deep concern to all professional accountants. Leaders in the profession and technical bodies in professional accounting organizations are concentrating on programs to alleviate some of the burdensome liability problems facing the profession.

Summary

In summarizing, I refer back to the final era selected by Brown and Salquist—the one they label, "Conflict and Uncertainty," beginning in the 1970's. They cite public criticism of accounting principles, current judicial concepts of auditors' legal liabilities, loss of professionalism in auditing through increasing standardization and uniformity of techniques, and challenges regarding forecasting, interim reporting, and current value reporting—all as the sources of the profession's conflict and uncertainty. Later in their summary, they mention these same factors as those that are bound to have a disruptive effect on the profession. They also restate their views that auditing has not been characterized by systematic and orderly development and that it has had no well defined path and predetermined goals. They conclude that you could expect little more than chaotic development from auditing since the work itself is chaotic in nature. I find myself in complete disagreement with these conclusions.

Their initial listing of public criticisms of accounting principles as a source of conflict and uncertainty leads me to believe that the authors, together with many other critics of the profession, have let the APB struggles with principles completely overshadow a very orderly evolution and development of auditing. I believe that my outline of the milestones and landmarks of the last forty years present an entirely different picture. I trace a well defined path of development of auditing standards and procedures beginning in 1941. It outlines how numerous hurdles were overcome in achieving predetermined goals.

The progress in educational areas has been effective. The programs and courses offered today make it possible for any man in the profession to obtain the training needed to meet changing conditions of technological and environmental nature. The advent of computers and electronic data processing, the increased use of statistical sampling, extensions of audit services to banks and insurance companies, have all been provided for in training programs of high quality. These developments, together with the Institute's uniform examination program, have moved the profession in the United States into a position of leadership of the field in the world. It is in this position that I believe we view the current state of affairs.

The Nature of the Work. Professional auditing has the same characteristics as most other professional work. The auditor's time is not his own, it's his client's. The client is not interested in how busy he is. He is interested in when his auditor is going to apply his very best professional talent to the company's problems and meet their deadline in completing the work. This may seem like a chaotic state of affairs to some. The well qualified auditor has learned to live this sort of a life, just as the doctor and the lawyer have. He knows that once he

has accepted an engagement, he has offered himself as one having all the qualifications to perform in accordance with the gospel of generally accepted auditing standards. And when he sits down on the job, he knows full well that he has all of those responsibilities of being independent in attitude and performing with due professional care in planning and supervising and formulating his report on the engagement. There are very few cases that get into the courts where the auditor is flawless in performing according to those personal standards and standards of field work.

I think I have seen most of the significant landmarks in auditing history over the last forty five years that have led us to our present position of a learned profession of well qualified men. If I were to choose one word to describe this evolution in place of the authors' word, "chaotic," it would probably be the word, "stolid."

There *are* uncertainties and deep concern over the current court decisions regarding accountants' liabilities. Quite frankly, I don't know how we could be much better organized than we are in the profession to solve these problems. I believe they will be solved in a manner that will not discredit nor injure the profession's ability to continue performing its important services to the financial community, and to society as a whole.

I see nothing chaotic or disruptive about the trends toward current value reporting, publishing forecasts, questioning the audit scope, and the like. They do involve controversial and critical issues. But I don't view each as a new crisis. I think we are inclined to get into the rut of assuming that a new crisis looms every other day. We have the energy crisis, the ecology crisis, and the current value reporting crisis. Secretary Connally responded to one of these new loomings the other day by saying that we have vast resources of hydrocarbons and he doesn't think we are going to run out of a clean supply of energy for many hundred years. I feel much the same way about the accounting profession. We have vast resources of well organized talent to cope with our problems and I think these resources will not be exhausted before the problems are solved.

If our client's management decides that he needs our professional opinion on his interim financial statements or on his annual forecast of operations, I think we can find a reasonable way to provide the opinion he needs. We have been doing this in isolated situations for as many years as I can remember. I am sure that many will oppose the forecast problem with arguments that we just cannot become soothsayers, just as they said we would have to become appraisers in order to have meaningful contact with physical inventories. We have the capacity needed to formulate the groundrules and train the people to perform, if we are called upon for these additional services.

I don't believe anyone in the auditing profession should have fears about light being shed on the extent of their audit testing and the procedures they employ. There have been some tremendous changes in the last twenty years resulting from more extensive use of statistical sampling, and with learning how to audit through computers. By far the principal purpose of the auditor's tests of detailed transactions, however, is to establish his own opinion as to the adequacy of internal controls for producing reliable financial data. The auditor's review of the internal administrative controls is the basis of his appraisal of the general character of the client's organization and management. All of this bears

heavily on his judgment when issues arise over accounting measurement choices and alternative reporting procedures.

I am glad to see the authors finally conclude with confidence that the auditing profession will become an even more constructive factor in the financial arena. I'm glad that my experience in the auditing arena has left me with more confidence than they have that the profession can do a rigorous job of defining the necessary goals and achieving them.

2

What are the Courts Saying to Auditors?

A. A. Sommer, Jr.
Calfee, Halter, Calfee, Griswold & Sommer, Attorneys at Law

The acquaintance of accountants with courts is not a new phenomenon. In 1954 Saul Levy, in *Accountants' Legal Responsibility*,[1] said that in England cases involving accountants had been quite numerous and went back more than sixty years. These early cases were really part of two developments. First, they were part of the development of English common law concerning liability which might attach to spoken or written statements if they were negligently made: Was there an action? If so who might maintain it? What were its elements? Second, they were part of the development of English corporation law embodied largely in the English Companies Acts which progressively created stricter standards of responsibility for officers and directors of English corporations, and for their auditors as well.

Common Law Developments

Most of the earlier cases in England and in the United States arose in common law situations, i.e. they did not arise out of statutorily created duties. The cases presented a wide variety of situations in which auditors were charged either with falsification or recklessness or simply negligence and the courts were largely concerned with relating the kind and degree of fault to the situations of those who might have a recovery because of the fault.

In this country *Ultramares v. Touche*,[2] decided in 1931 by the New York Court of Appeals (the highest court in New York state), fairly definitively marked off the limits of accountants' liability under common law in this country for a generation. In that case, the New York court, speaking through Judge (later Justice of the United States Supreme Court) Benjamin Cardozo, articulated these principles:

1. Fraudulent conduct, or conduct so reckless as to be tantamount to fraud, created liability not only to the accountant's client but to third parties as well who were injured as a consequence.

2. Negligent conduct may create liability to the client because of "privity," but there would be liability to third parties only if the preparation and transmission of the financial statement and opinion were the "end and aim of the transaction." Thus if a client engaged an auditor to prepare audited financial statements for the express and understood purpose of giving them to a specific bank, the bank might have a claim if the auditor were negligent. Other cases elaborated this to encompass members of a circumscribed class of persons; thus if the auditor

understood the client intended to seek bank financing, then any bank from which such financing was sought might have a claim based on negligence. But the use of the statements to secure the financing still had to be "the end and aim of the transaction" between the auditor and his client.

Statutory Law—The Securities Acts

These principles remained relatively intact into the 60's (and for that matter in many states are still apparently "good" law: recent litigation in Florida has expressly followed the *Ultramares* case). The most significant extension of potential liability for accountants occurred in the United States Congress when it adopted the Securities Act of 1933. Under this statute accountants (included in the broader word "experts" used in the Act) might have liability with respect to the contents of financial statements used in registration statements with their consent unless they could show as a *matter of defense* they had ". . . after reasonable investigation, reasonable ground to believe and did believe, at the time such [expertised] part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . ." (Section 11).

It is difficult now, almost four decades later, to understand the impact this enactment had not only upon auditors, but the underwriting and business community in general. The Investment Bankers Association predicted that ". . . its practical results . . . will be to suspend the underwriting or distribution of many capital issues by responsible persons . . . ."[3]

For the first time issuers might be held liable for misstatements in a registration statement (part of which constituted the prospectus required to be given to purchasers and in many instances offerees of registered securities), regardless of conventional notions such as privity, due care, reliance, causality and the like. The burden and danger thrust upon others beside the issuer—its directors, certain officers, "experts" (including accountants), underwriters—was slightly less burdensome, but nonetheless a significant departure from common law standards for liability. An accountant might be liable to the purchaser of the registered security even if the purchaser had not relied in the slightest on the auditor's opinion and did not in fact even know of the opinion. The liability flowed simply from a material omission or misstatement in the audited statements, unless the accountant could show reasonable investigation and that he had reasonable ground to believe there was no misstatement or omission.

This departure from earlier law, virtually all of which in this country had been judge-made, alarmed many leaders of the profession not the least of whom was the venerated George O. May, who said grimly,

> I cannot believe that a law is just or can long be maintained in effect which deliberately contemplates the possibility that a purchaser may recover from a person from whom he has not bought, in respect of a statement which at the time of his purchase he had not read, contained in a document which he did not then know to exist, a sum which is not measured by injury resulting from falsity in such statement.[4]

Despite the misgivings of Mr. May and others, the implications of the

Securities Act of 1933 were never explored judicially to any significant extent until 1968 when the United States District Court in New York rendered its opinion in *Escott v. BarChris Construction Corporation*[5] which is discussed hereafter.

In 1934 the Congress enacted the Securities Exchange Act of 1934 which provided, among other things, for the filing of registration statements and periodic reports by listed companies including certified financial statements. Again the statute contained provisions for liability that could be asserted against auditors, but in many particulars these perils were less frightening; very little litigation has been prosecuted successfully against anyone under Section 18 of the 1934 Act, but this is no assurance that it may not be the source of such in the future.

Effect of the Securities Acts

The Securities Act of 1933 and the Securities Exchange Act of 1934, of course, did not repeal in any way previous common law holdings, such as the *Ultramares* case. Previous litigation had been largely in state courts and generally it was state substantive law that was determinative of liability.[6] Thus the enactment of these federal measures did not explicitly broaden the scope of accountants' liabilities except when they consented to the use of their opinions in registration statements under the 1933 Act or in filings under the 1934 Act. With regard to the ordinary run of mine matters the liability of auditors still depended upon state law with its then fairly narrowly drawn concepts.

A process, an event plus a process, and broader cultural and political movements have combined to change this.

The process is the subtle interaction of statutory law and judge-made law. This has been expressed by Justice Oliver Wendell Holmes, Jr. and James M. Landis, once dean of Harvard Law School.

Justice Holmes wrote,

> [I]t seems to me that courts in dealing with statutes have been too slow to recognize that statutes even when in terms covering only particular cases may imply a policy different from that of the common law, and therefore may exclude a reference to the common law for the purpose of limiting their scope.

And Landis, in the same vein, stated:

> . . . much of what is ordinarily regarded as "common" law finds its source in legislative enactment.[7]

Thus statutory notions, literally unconcerned with more than a narrow band of common law, leak through the edges into other domains. As will be clear shortly, this has been a significant factor in the expansion of liability dangers for the accounting profession.

The Securities and Exchange Commission Enacts Rule 10b-5

Assisting in strenuous fashion this development has been the event plus a process. The event was the adoption by the Securities and Exchange Commission in 1942 of Rule 10b-5 under the 1934 Act. This rule was quickly adopted by the Commission pursuant to a broad rule-making power under the 1934 Act

for the purpose of curing a peculiar hiatus in the scheme of federal securities regulation that provided a fulsome system of penalties for the fraudulent seller of securities, but was completely silent as far as fraudulent purchasers were concerned.

The terms of Rule 10b-5 are extremely broad:

> Rule 10b-5
> Employment of Manipulative and Deceptive Devices
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of a national securities exchange,
> (1) to employ any device, scheme or artifice to defraud,
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or
> (3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Notably absent in this Rule are many of the particularizations contained in the 1933 Act defining the conditions of liability; particularly absent is any statement of a defense being available if there is a showing of reasonable investigation and reasonable belief. There is no specification of those to whom liability may run, there is no measure of damages, there is no limitation upon those who may be held responsible: "It shall be unlawful for any person . . . ."

Rule 10b-5 was intended purely as an enforcement tool for the Commission.[8] In 1946 an imaginative plaintiff's counsel and a creative court combined to yield the conclusion that Rule 10b-5 was not only available to the Commission for enforcement purposes but was available to private claimants as well who could establish they had been harmed by a violation of the Rule.[9] Thus was opened the floodgate through which oceans of litigation have passed in the intervening twenty-six years, virtually to the point that other more explicit liability-creating provisions of the federal securities laws have been vastly overshadowed as litigants sought the benefits of Rule 10b-5.

Causes of Recent Litigation

But these somewhat technical legal developments are not sufficient to explain the explosion of litigation that has confronted accountants during the past ten years. Broad social developments have been the soil in which these seeds have become rooted and have yielded often bitter fruit.

First, there has been the emergence of the consumer, so dramatic that it has been suggested we are entering upon the "age of the consumer." The whys of the broad phenomenon are too complex to narrate here, but it is clear that restlessness with the impersonality of technology, political necessities, the emergence of a new brand of populism (Naderism is one form of it), have combined with legal resourcefulness to bring about an equalizing of the position before the law of the consumer and commercial interests (or perhaps a disequilibrium in favor of the consumer). The courts have joined with legislatures to expand the litigation potential of the class suit and develop other means of redress for wrongs

which, while existing in the past, because of inertia or legal technicalities were never susceptible of effective redress. Legislatures, state and federal, have tripped over each other providing protection for consumers.

Much of this, of course, has familiar ring to those familiar with the development of federal securities law. Most of the devices now urged for consumer protection have their counterparts in this structure dating back decades: disclosure ("Warning: The Surgeon General Has Determined That Cigarette Smoking Is Dangerous to Your Health" parallels the scheme of the 1933 and 1934 Acts [as well as parts of other SEC-administered statutes]); regulation (the requirement that more and more products must be approved by federal authority before they can be sold to the public sounds surprisingly similar to the Investment Company Act of 1940 governing mutual funds); licensing of purveyors (the requirement of federal licensing in many areas parallels the provisions of the 1934 Act requiring the licensing of broker-dealers).

As people have become alert to the possibility of redress in their many roles as consumers, the potentials of the federal scheme of securities regulation have been explored and used.

Consequences of Professional Stature

Also the accounting profession itself has become even more pronouncedly a profession. Levy in 1954 could write, "When speaking of public accountancy as a learned profession it must be realized that in this country, at any rate, it is a relatively new profession . . . ."[10] If question there ever was, surely it is beyond cavil that accounting is now a highly developed profession which has gone through many travails in recent years to develop principles of conduct and principles governing the quality of its work. As this has happened, it has not escaped the notice of those of the public who feel they have suffered harm as a consequence of shortcomings of the profession, either as a whole in failing to establish sufficiently high standards or because of individual members who have failed even to reach those which have been articulated. The possibility of this was foreseen:

> Thus as the legal liabilities of professional accountants in the United States have seemed to be extended by court decisions and legislation, the [American] Institute [of Certified Public Accountants] has become increasingly aware that pronouncements and rules which encourage higher standards of performance might be used against its members unfairly in the courts.[11]

Other circumstances could be recounted which have led to the proliferation of litigation against accountants: the dynamics of the economy, with the multiplication of mergers and complicated financial transactions involving publicly held companies; more and more imaginative use of accounting principles to achieve financial magic (e.g. the pooling concept); the participation of vast numbers in the market (31 million shareholders plus millions more who participate indirectly through mutual funds, pension and profit sharing trusts and other pooling devices); the development of more exacting standards of disclosure and the vastly increased importance of information in the investment process.

The Voice of Litigated Cases

In our way of doing things often the situations created by social and economic forces are not resolved in a systematic fashion aimed to embrace in a broad, expansive manner the full range of the problem, as is sought to be done through such legislation as the Uniform Commercial Code, or in a different milieu, the civil codes that characterize continental legal systems. Rather it is the genius, and often the frustration, of our system that emerging broad-scale problems are dealt with through the medium of litigating particular fact situations and through this process, accompanied by skilled (and sometimes not so skilled) interpretation, the law is moved along. Thus no single case resolves more than the litigation confronting the court; no single case purports to codify an area of human conduct. But cases, analyzed one with the other, can often provide clues for solving other controversies and can be used to shape standards of conduct, lay and professional, to avoid future legal liability.

What the courts are saying to auditors, then, is not an integrated set of precepts; they are not weaving a properly proportioned whole. They are simply deciding cases and in the process they are using established legal principles, they are modifying others, they are bringing to the surface principles that may long have been latent, they are producing results in particular litigation which they conceive to be the just, rational result—in that case.

Five cases have been the most noted in this present period of development: *Escott v. BarChris Construction Corporation*, noted earlier; *Fischer v. Kletz;*[12] *U.S. v. Simon;*[13] *Drake v. Thor Power Company;*[14] *SEC v. Bangor Punta Corporation.*[15] Of less direct significance, but nonetheless an important part of this pattern, is the case of *Gamble v. Gerstle-Skogmo, Inc.*[16]

BarChris Construction Corporation

The first of these (though not first in time), and in some respects the least singular, was the *Escott* case. In this case purchasers of convertible debentures of BarChris Construction Corporation sued the corporation (which was bankrupt at the time of suit), the directors, certain officers, the underwriters and the auditors because of alleged misstatements and omissions in the registration statement for the debentures. All of the defendants were found liable under Section 11 of the Securities Act of 1933, the provision governing liabilities arising out of registration statements. The auditors were found wanting in two areas: first, it was found that there were errors in the audited statements on which they opined and that they had not exercised due care; and second, it was found that they had failed to exercise due diligence in conducting the "S-1 review" covering developments between the audit date and the effective date of the registration statement.

The case is less noteworthy for the enunciation or development of legal principles than it is because it was the first systematic treatment of the responsibilities of auditors under the 1933 Act (an earlier case, *Shonts v. Hirliman,*[17] the only previous case dealing with the responsibilities of auditors under the 1933 Act, was almost universally believed to have been wrongly decided). The court did however state some significant points. It found that the standards for the S-1 review contained in Statements on Auditing Procedure No. 33 adopted by

the AICPA were sufficient in outlining procedures for satisfying the due diligence standard and it further found that the standards established by the firm internally were compliant with SAP No. 33. The fault of the auditors, said the court, was in failing to comply with their own established standards.

There is some reason to believe that the court was, at least in some particulars, unduly harsh on the auditors and perhaps held them to higher standards than it should have.[18]

However, the case did remind auditors of the perils latent in Section 11 and undoubtedly led to stricter standards among them.

Yale Express

The second case of significance was *Fischer v. Kletz*. In this case auditors for Yale Express Systems, Inc. during the course of making some special studies for the client unrelated to their auditing function discovered that the statements which they had certified contained material errors. The court found fault with their failure to make this known other than to management when it came to their attention; rather they allowed the statements to continue unquestioned for a considerable time while those making transactions in the securities of Yale Express in the marketplace presumably relied upon them. The court found this a violation of common law principles, basing its opinion largely upon the Restatement of Torts, which is an authoritative effort to systematize and clarify common law tort principles, and left open the possibility of a violation of Rule 10b-5. The duty found by the court to make this disclosure has been codified in Statement on Auditing Procedure No. 41.

Continental Vending

The case that rocked the accounting profession far more than any of the others discussed herein, and with good reason, and the one that may in the long run do most to adjust accounting standards and practices was *U.S. v. Simon*. In this case two partners and an associate of a national firm of auditors were indicted for alleged violation of the Federal Mail Fraud Statute and the Securities Exchange Act of 1934. The charge was that a footnote in the financial statements of Continental Vending Machine Corporation for the year ended September 30, 1962, was materially misleading and suffered from material omissions, and that this was the result of knowing conduct by the defendants. After a first trial ended in a hung jury, a second trial brought their conviction.

The Court of Appeals for the Second Circuit, in a unanimous opinion written by Judge Henry J. Friendly, one of the most knowledgeable federal judges in financial, securities and accounting matters, affirmed the convictions.

It is clear from reading the charge of the trial judge to the jury, a charge which in affirming the Court of Appeals confirmed as a correct statement of the law, and from reading the Court of Appeals opinion, that the courts thrust compliance with generally accepted accounting principles into a position subsidiary to fair presentation. In effect, the courts said that not only must financial statements be prepared in accordance with generally accepted accounting principles, they must also "fairly present" the financial condition of the company and whatever else they purport to present. In the lower court's words,

A firm of public accountants . . . engaged to perform an independent audit, represents that it will perform the audit in accordance with generally accepted auditing standards and accounting principles and that it will render an opinion, based on its audit, as to whether the financial statement of the company fairly presents its financial position and the results of its operations.

Proof that a defendant, in conducting the 1962 audit, departed from such auditing standards, or participated in the preparation or approval of a financial statement that did not fairly present Continental's financial position, results of its 1962 operations in accordance with generally accepted auditing standards and accounting principles, is evidence, not necessarily conclusive, that the defendant did not act honestly and in good faith, and that statements contrary to such standards and principles may have been materially false or misleading. On the other hand, proof that the defendant did act in accordance with such generally accepted auditing standards and accounting principles is evidence which may be very persuasive *but not necessarily conclusive* that he acted in good faith, and that the facts as certified were not materially false or misleading.

* * * * *

So the auditor's responsibility in accordance with his engagement is, first, to render an opinion that must satisfy the auditor that the statement fairly presents the results of the operations about the financial position of the client; and, second, to be satisfied that the statement contains no misstatements of fact, or, at least, no misstatement of facts known to the auditor.

The critical test, therefore, is whether the financial statement here, as a whole, fairly presented the financial condition of Continental as of September 30, 1962, and whether it accurately reported the operations for fiscal 1962. (emphasis supplied)

At the Seaview Symposium on Ethics in Corporate Financial Reporting held in the latter part of 1971, it was clear that this notion of the primacy of fairness over generally accepted accounting principles is less than unanimously acceptable to accountants.[19] This is understandable. Most accountants probably feel more comfortable dealing with the principles that have been warp and woof of their educational and professional experience than they do in placing their professional reputations (not to mention their finances) at the mercy of determining compliance with a vaguely defined standard that is more ethical than legal or financial.

And yet this notion is not radical. It has been suggested in the past. In the *Associated Gas and Electric Company* case decided by the Securities and Exchange Commission in 1942, the Commission, after an extraordinarily detailed examination of alleged accounting improprieties in the accounts of Associated Gas and Electric, shifted to what it considered more basic considerations and said:

We think, however, that too much attention to the question whether the financial statements formally complied with principles, practice and conventions accepted at the time should not be permitted to blind us to the basic question whether the financial statements performed the function of enlightenment, which is their only reason for existence. Each of the accountants' certificates in question contained the opinion that, subject to various qualifications therein, the financial statements fairly presented the financial condition of the registrant, in accordance with generally accepted accounting principles. If that basic representation was not ac-

curate as to the financial statements as a whole, no weight of precedent or practice with respect to the minutiae of the statements could justify the accountants' certificates. . . . For the average investor [read layman?] the financial statements of this system contain not a hint of the rot hidden beneath the surface of this holding company system.

We believe that, in addition to the question whether the individual items of financial statements are stated in accordance with accounting principles, practices and conventions, there must be considered the further question whether, on an overall basis, the statements are informative.[20]

Liability to Third Parties

Beginning in 1951 the carefully delineated common law restraints on the imposition of liability to third parties on auditors laid out in the *Ultramares* case began to erode. In a long, rather brilliant, dissenting opinion, Lord Justice Denning in *Candler v. Crane, Christmas & Co.*[21] laid out what he conceived should be the broad principles of liability to third parties for negligence in these words:

> [To] whom do these professional people owe a duty? They [accountants] owe the duty, of course, to their employer or client; and also I think to any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts, so as to induce him to invest money or take some other action on them . . . . *In my opinion accountants owe a duty of care not only to their own clients, but also to all those whom they know will rely on their accounts in the transactions for which these accounts are prepared.* (emphasis supplied)

Thirteen years later this viewpoint became the law of England in *Hedley, Byrne & Co., Ltd. v. Heller & Partners Ltd.*[22] Four years later a sizable dent was made in the earlier doctrine in this country in *Rusch Factors, Inc. v. Levin.*[23] The Court there peered into the same pit of danger that had caused Justice Cardozo to recoil from finding liability to third parties for simple negligence and said:

> The wisdom of the decision in Ultramares has been doubted . . . and this Court shares the doubt. Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional misconduct? Isn't the risk of loss more easily distributed and spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public?

The Court then added this pregnant thought:

> Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession?

Paralleling this expansion of liability under common law has been the development under Rule 10b-5. In *Drake v. Thor Power Company,* the federal district court in Chicago determined that auditors could be liable under Rule 10b-5 if they were negligent in giving their opinion.

These cases, of course, create significant dangers for auditors. If simple negligence is sufficient to establish monetary liability, and that liability runs to all those whose reliance "can be actually foreseen," isn't the door opened for appalling damages? An error in the audit of General Motors or American Telephone & Telegraph or any other substantial publicly held company might result in catastrophic consequences. The hovering hope that such a burden may not be inflicted on auditors is the fact that it is not yet clear whether negligence can create monetary liability for a Rule 10b-5 offender who did not participate in the purchase or sale of securities. In *SEC v. Texas Gulf Sulphur Co.*,[24] a case in which one of the charges was that the company had put out a misleading press release as a consequence of negligence, Judge Friendly said in his concurring opinion:

> The consequences of holding that negligence in the drafting of a press release . . . may impose civil liability on the corporations are frightening.

Despite this uncertainty, however, it is reported that accounting firms or their insurance carriers have paid several millions of dollars in settling claims that appear to have been based upon negligence.[25]

Responsibility for Adequate Disclosure

Two other cases are of importance in analyzing the developing responsibilities of accountants, though neither of them involved accountants as defendants.

In the first, *Gerstle v. Gamble-Skogmo, Inc.*, the District Court determined that a proxy statement used in soliciting approval of a merger of General Outdoor Advertising Co. with Gamble-Skogmo was misleading. The financial statements of General carried certain fixed assets of the company in accordance with customary accounting principles: historical cost less depreciation. However, the court stated, without suggesting that the financial statements were incorrect, that in addition to that information there should have been disclosed additional information indicating a market value higher than book since there was significant evidence of the intention of Gamble-Skogmo after the merger to dispose of the assets by sale, there had been a number of sales of similar assets at prices substantially above book, and the company had received offers and appraisals for the remaining ones that indicated market value higher than book.

In the next case, *SEC v. Bangor Punta Corporation*, the court went further and indicated that in the somewhat special circumstances of that case a significant asset, the stock of the Bangor and Aroostock Railroad, should have been written down on Bangor Punta's balance sheet because of indications that its value had become less than the carrying value. In that case, for somewhat obscure reasons, Bangor Punta had put the railroad on its books at $18.4 million, an amount based upon an appraisal; this treatment had been allowed earlier by the SEC. The court determined that, given the status of negotiations looking toward the possible sale of the stock of the railroad, it should have been written down to about $5 million, the amount which was being discussed with a potential buyer. The court remarked that its requirement of this write-down might not be required in ". . . cases where book carrying figures are in accordance with principles of conventional transactional accounting or where circumstances might be different."

Both of these cases, admittedly each posing somewhat unique problems, suggest that permissible accounting treatment may not be sufficiently reflective of economic reality to stand alone: either additional information must be disclosed or the financial statements must be modified to make fuller disclosure.

Conclusions

In the light of all the above, what *are* the courts saying to auditors?

Obviously, the courts do not speak with a single voice, and they speak always in the context of the particular cases before them. There are, however, some conclusions that are suggested by this discussion.

First, the performance of the accounting profession is going to be increasingly subject to judicial scrutiny. As the task of bringing class suits has been moderated, and as potential plaintiffs and their counsel have witnessed the ease with which judicial intervention may be secured, accountants increasingly may expect to have their work thrust into the judicial arena either by private litigants or the SEC.

Second, for the most part the courts are willing to let the profession articulate accounting principles and auditing standards, but they are inclined to look beyond conformity to accounting principles for answers to what they consider a more basic concern: do the financial statements *fairly* and *meaningfully* inform the investor? If they do that, the court would probably be disinclined to fault heavily an auditor who may have erred in the application of accounting principles; if they don't, as is evident from the *Simon* case the court will not be deterred from penalizing the auditor because of heavy evidence of conformity with the principles.

Third, while the courts and the SEC do not appear to be insisting that financial statements must be reduced to kindergarten simplicity, still they do appear to be insisting that they have intelligibility to the layman. In 1947 the Commission stated:

> It is not enough to say that here perhaps much . . . of the factual background was given in footnote data. . . . [*E*]*ven if* [*all significant data*] *had been given there is an additional obligation to present the material in a way in which it will be useful to the informed but less sophisticated readers.* (emphasis supplied)

And a Federal District Court said:

> *The purpose of the financial statements is to inform the man on the street, and the underlying policy of the Securities and Exchange Acts and of Rule 10b-5 is to assure that he can have truthful information in buying securities,* regardless of the intended victim of the fraud. Moreover, the defendants have set themselves up to be independent certified public auditors. As such, they have assumed a peculiar relation with the investing public. As accountants, the defendant clearly cannot be immunized from suit. (emphasis supplied)

It is not enough to prepare financial statements in a manner that would permit intelligent interpretation only by the trained accountant or the investment banker. Above everything else, they are demanding that the statements *disclose* and that this disclosure be intelligible and helpful to more than a handful in understanding the financial condition and the operations of the company.

Fourth, when the profession has established standards, the courts will rely

heavily upon the extent to which the professional work conforms to those standards. This is not to say, however, that if a court found a standard or principle lacking it would not fall back on the notion found in the McKesson & Robbins case of the thirties decided by the SEC to the effect that the entire profession had been insufficiently cautious.[26]

With the courts more heavily involved in monitoring the way in which accountants do their work, the pressure on the profession to find means of forestalling further disaster is heavy. Certainly to some extent the increased urgency of the effort to define accounting principles and eliminate alternatives is a fruit of this judicial scrutiny. Too, surely in some measure the in-depth efforts being made by the Wheat and Trueblood groups were undertaken in hopes that a more effective means of establishing accounting principles and a better definition of the objectives of financial statements might allay some of the hazards.

It is sometimes said that the courts are "hostile" to the accounting profession. This is a doubtful proposition. The courts are concerned, as are the SEC and state securities authorities, as well as the self-regulatory agencies, with the maintenance of fairness and honesty in the securities markets. Crucial to that task is disclosure. And central to disclosure is financial information. As long as this is so the courts will scrutinize with care how those who purport to give that financial information a higher degree of credibility perform their role.

After all, the accounting profession came into existence to provide to various parts of society assurances that could not be secured by relying upon the unverified assertions of preparers of financial statements. The profession had its inception in the notion that accountants, as members of a learned profession, would exercise independence, would not prostitute their skills for the venal purposes of their employers, would be answerable to those who employed them and those to whom they addressed their conclusions at the behest of those who employed them. In the earliest days of the profession their efforts were designed to assure honesty among owners in an enterprise, credibility to the owners' or managers' assertions to existing or potential creditors. In these roles those who relied upon them were very limited in number and generally the risks, though large for the time, were nothing as compared with those involved in present-day financial transactions. The role of auditor is essentially the same. The audience, however, is larger and the stakes are higher.

Footnotes

1. Published by American Institute of Accountants. Unfortunately this work is now out of print and as is evident from the following discussion somewhat out of date.
2. 255 N.Y. 170, 174 N.E. 441 (1931).
3. Quoted in Landis, *The Legislative History of the Securities Act of 1933,* 28 Geo. Wash. L. Rev. 29, 40 (1959).
4. John L. Carey, *Rise of the Accounting Profession,* Vol. 1, p. 192.
5. 283 F. Supp. 643 (S.D.N.Y. 1968).
6. This was also true in federal courts after *Erie Railroad Co. v. Tompkins,* 304 U.S. 64 (1938).
7. James M. Landis, "Statutes and the Sources of Law," in *Harvard Legal Essays,* 214.
8. Sec. Ex. Act Rel. No. 3230, May 21, 1942.
9. *Kardon v. National Gypsum Co.,* 69 F. Supp. 512 (D.C. Pa. 1946).
10. Levy, *op. cit. supra* note 1 at p. 5.
11. Carey, *op. cit. supra* note 4 at p. 5.
12. 266 F. Supp. 180 (S.D.N.Y. 1967).
13. 425 F.2d 796 (2d Cir. 1969), *cert. denied,* 400 U.S. 827 (1970).

14. 282 F. Supp. 94 (N.D. Ill. 1967).
15. CCH Fed. Sec. L. Rep. ¶ 93,159 (1971).
16. 298 F. Supp. 66 (1969).
17. 28 F. Supp. 478 (S.D. Cal. 1939).
18. A. A. Sommer, Jr., "Accountant's Counsel—Advice to My Client," 24 *Bus. Law.* 593 (1969).
19. John C. Burton, "Ethics in Financial Reporting," *Financial Analyst's Journal,* Jan.-Feb. 1972, p. 49.
20. *In the Matter of Associated Gas and Electric Company,* 11 SEC 975, 1058-9 (1942).
21. High Court of Justice, King's Bench Division [1951] 2 K.B. 164.
22. [1964] A.C. 465 [House of Lords, 1963].
23. 284 F. Supp. 85 (D.C.N.Y. 1968).
24. 401 F.2d 833 (2d Cir. 1968), *cert. denied sub. nom., Kline v. S.E.C.,* 394 U.S. 976 (1969).
25 *The Wall Street Journal* reported the Drake case above was settled by Thor and its auditors for $475,000 (week of June 8, 1970).
26. "In the Matter of McKesson & Robbins, Inc.," SEC Accounting Series Release No. 19.

Discussant's Response to What Are the Courts Saying to Auditors?

Russell A. Taussig
University of Hawaii

Mr. Sommer, in his excellent paper, clearly and forcefully tells us that the courts are saying to the auditors: "the ante has been raised in the auditing game."

Whatever else the cases he cites imply, they indicate business will be good for attorneys in the liability area throughout the 1970's. In my opinion, these cases also will result, as with McKesson-Robbins, in an extension of auditing standards and an improvement in financial reporting.

Mr. Sommer summarizes the significant characteristics of the recent cases under three major headings.

1. The courts are making it much easier to sue the auditors.
2. The courts are asking auditors to establish generally accepted accounting principles; but where those principles are lacking, the courts are filling the voids.
3. The courts are holding the profession to its announced standards, but where the profession has been overly restrictive in defining such standards the courts are interpreting them quite broadly.

Let us consider these three characteristics concretely in terms of another case, that has yet to go to trial, that of National Student Marketing.

A civil action filed February 3, 1972 by the Securities and Exchange Commission against National Student Marketing Corporation, its auditors and two law firms in U.S. District Court (Washington, D.C.) asks for injunctive and other relief.[1] At this early stage, all we have is a complaint. The actual facts, as substantiated by the evidence and decided on by the courts, may differ from the allegations. Nonetheless, the legal concepts and accounting issues are of such immediate significance that they are worthy of discussion at this time. Let us, therefore, review the allegations of the SEC, bearing in mind the possibility of revisions before final judgment is in.

The SEC charges the defendants with fraud and deceit. If the SEC prevails, this case will expand the potential liabilities of independent accountants under Rule 10b-5 of the 1934 Securities Exchange Act for audited financial statements.

It also will enlarge the responsibilities of auditors for comfort letters beyond those delineated in Statement on Auditing Procedure No. 48. Consistent with its contemporary activist policy, the SEC seeks injunctive relief not only against the registrant but also against others, including Peat, Marwick, Mitchell & Co.

Allegations by Securities and Exchange Commission

The complaint against the auditors contains basically two charges:

1) Deficiencies in the financial statements prepared between 1968 and 1970;
2) failure to report the contents of a 1969 comfort letter to the SEC.

The Story of National Student Marketing. National Student Marketing Corporation grew in two years from $723,000 of sales to $67.9 million. Cortes Randell, the founder and chief executive, captured the imagination of financial analysts and institutional investors with merchandising schemes ranging from computer-matched dating to half-fare cards for American Airlines. Wall Street wanted to believe in Cortes Randell, in view of the $45 billion annual disposable income of the youth market.

NSM was bought out at $6 in April 1968 and soared to a high of $144 by December 15, 1969—an increase of 2,300 per cent. The decline was equally dramatic. On February 1, 1972 NSM was selling at $9—an aggregate loss of over $450 million.

To what extent were these losses due to the cupidity of the investors? To what extent, if any, should the auditors absorb the losses? For an understanding of these questions, let us examine the SEC allegations in further detail.

Accounting for Unbilled Contracts. In the first place, the SEC asserts the 1968-69 financial statements were in error because contracts in progress were improperly recorded as receivables. For example, the SEC claims the balance sheet at August 31, 1968 overstated assets approximately $1.7 million by the improper recording of unbilled accounts receivable, and pre-tax earnings for 1968 were overstated approximately $696,000 out of a total of $699,000.

Subsequent to the issuance of the 1968 statements, management wrote-off unbilled accounts receivable of approximately $1,000,000. Cortes Randell stated the change was to put the company on a more conservative basis of accounting. However, the SEC claims that the write-off was in recognition of the fact that these unbilled receivables never existed or were otherwise uncollectible. Moreover, the SEC claims these changes were not adequately disclosed in the 1969 statements. The SEC also charges similar misstatements in the 1969 financial statements. We must await the answers of the defendants, and testimony of witnesses, to appraise the validity of these charges and to judge whether the financial statements were, in fact, erroneously prepared, or, simply were prepared according to the best evidence available at the time—later to be found wanting on the discovery of subsequent events.

Accounting for Sale of Subsidiaries. A second claim of the SEC concerns 1969 gains from the disposition of two wholly owned subsidiaries. It is claimed the sales not only were not at arm's-length, but also were initiated after 1969 and dated back to inflate the profits for that year. Moreover, Cortes Randell transferred some of his own NSMC stock to the purchasers, which they then used as collateral for the acquisitions. The SEC charges PMM failed to conduct its examination in accordance with generally accepted auditing standards once it knew of Randell's involvement in these transactions. As in Continental Vending, discussed by Mr. Sommer, we find auditing questions arising from the stock transactions of the holder of a controlling interest. Should the auditor expand the scope of his engagement when he discovers transactions that indicate a potential conflict of interest?

The Comfort Letter, the Auditor, and the Public. In addition to the fore-

going allegations relating to the audited financial statements, the SEC is also bringing charges regarding a comfort letter requested by counsel in connection with the merger of NSM and Interstate National Corporation on October 31, 1969.

As a result of facts discovered during its regular annual examination for the year ended August 31, 1969, the auditors could not render a clean letter. They proposed the amortization of $500,000 of deferred costs against the nine months ended May 31, 1969, and they suggested the write-off of receivables and recording of other charges totalling approximately $300,000. PMM recommended that NSM should consider submitting corrected data prior to proceeding with the closing. (This information was conveyed orally; the written letter was not delivered at this time.) Interim statements were not revised. Stockholders were not informed. Nevertheless, the merger took place.

The SEC charges the auditors failed in accordance with their professional obligation to insist that the NSMC financial statements be revised in accordance with the comfort letter, and failing that, to withdraw from the engagement. The SEC moreover, claims that the auditors had a duty to come forward and notify the SEC or the shareholders as to the materially misleading nature of the unaudited financial statements. Here, as in BarChris, discussed by Mr. Sommer, the SEC is attempting to expand the scope of the auditors' attest function in connection with comfort letters.

Relief Sought by the SEC. The SEC in this civil action is asking basically for two things:

1) a permanent injunction restraining defendants from future violations of federal securities laws; and
2) a mandatory injunction requiring NSM to revise the 10-Ks filed between 1968 and 1970.

Any other lawsuit—possibly a class action for money damages—would, of course, necessarily have to establish its case independently of the current one. However, it would seem the discovery of evidence for such an action would be facilitated somewhat by the present case.

What then Are the Courts Saying to Auditors?

This case reiterates three important issues for accountants outlined by Mr. Sommer in his thoughtful and well balanced paper:

1) The SEC is escalating its activist role. National Student Marketing is the first major case against accountants (and others) where a business failure has not taken place.
2) The SEC is raising once again a possible expansion of the overriding ethical concept of "fairness."
3) The SEC's actions, if sustained, will greatly expand the responsibility of the auditor for unaudited financial statements.

The Activist Role of the SEC. We have seen in BarChris, Yale Express, and Continental Vending a new activist role for the courts—emerging after some 35 years of experience with the federal securities laws. *SEC v. NSMC* signals another stage in that activist role. This is the first major civil case brought by the Commission against a registrant, its accountants, and attorneys for alleged de-

ficiencies in financial statements arising out of a situation other than a business failure. It no doubt will not be the last. At least, criminal action was not asserted, as in Continental Vending. But what is the next logical step in the SEC's policing of financial information under the federal securities laws? Will the SEC seek to audit the auditors?

In Yale Express, BarChris, Westec and Continental Vending, claims against the accountants arose in connection with business failure. In National Student Marketing, no such calamity triggered SEC action. Perhaps the next step would be for the SEC to evaluate the quality of auditing on all financials covered by the 1933 and 1934 Acts. Suppose the SEC, under its broad regulatory powers, would attempt to review auditors' working papers—at least on a sampling basis? In my opinion the added cost of such a review of auditors' working papers by the government would not be justified in terms of additional and more reliable financial information for investors. However, it seems clear that the already thorough and generally excellent intra-firm review function that exists in all major accounting firms must be greatly expanded in the light of the new activist role of the SEC. The reviewing partner will want to look beyond the audit program. He will want to ask himself at the end of every engagement: "Would I invest my money in this company?" If his question raises doubts, he should proceed on the assumption that he might be called into court to justify each financial statement item. The reviewing partner should also ask himself as an investor, "What additional information (by footnote or otherwise) would I like to have?" This means the courts are saying to the auditors: increase the scope of your engagements; increase your manpower; increase your fees.

The Primacy of Fairness Over Generally Accepted Accounting Principles. Not only are courts saying to the auditors "expand the scope of your activities," they are also making promulgations about "fairness" in financial reporting, a concept which judges and lay juries are construing to take precedence over generally accepted accounting principles.

In Continental Vending, for example, Judge Friendly stated: "the critical test is not whether the statements were prepared in accordance with generally accepted accounting principles, but whether they fairly present financial information such that they contain no misstatements of fact, or, at least, no misstatements of facts known to the auditor." As Mr. Sommer comments in his paper: "the notion of the primacy of fairness over generally accepted accounting principles is less than unanimously acceptable to accountants." The concept of "fairness" is not operational. Fairness, like beauty, lies in the eyes of the beholder. To substitute it for generally accepted accounting principles would expose auditors to substantially greater hazards without proof that such a change would create a more liquid capital market.

The SEC is attempting to hold the defendants in NSM to the primacy of "fairness." The SEC charges PMM with misleading financial statements because:

1) the statements did not fairly present the facts; and additionally
2) the statements were not prepared in conformity with generally accepted accounting principles.

Why two separate complaints? Apparently, the SEC will try to establish both charges, but will be satisfied if it sustains one.

Action for Standard Beyond that Established by the Auditing Profession. Not only is the SEC apparently seeking to hold accountants for the primacy of fairness, but it also is attempting to require a standard of auditing beyond that required by the profession. At least, so it would appear from the comments of Victor M. Earle III, general counsel of PMM. The SEC charges the auditors should have insisted that NSM revise the financial statements in accordance with the comfort letter, and failing that should have withdrawn from the engagement and notified the SEC or the shareholders of the two companies. Victor Earle replied: "The plain implication of SAP 41 is that client confidences and state law and Rule 1.03 of the AICPA Code of Professional Ethics can be breached, if at all, only where the auditor has subsequently acquired information affecting his previously issued expression of opinion on audited financial statements.

"Here, the information acquired related to the company's previously issued unaudited financial statements as to which the firm had not expressed an opinion."[2]

While SAP 41 applies only to events discovered by an auditor subsequent to the issuance of an opinion on audited financials, other statements on auditing procedure cover the responsibilities of the auditor to disclose facts he has discovered pertaining to unaudited statements that make such unaudited statements misleading, particularly in connection with a proxy or prospectus. For example SAP 47 (September 1971) at paragraph 23 states ". . . [If the auditor] concludes on the basis of facts known to him that the unaudited financial statements [in a registration statement] are not in conformity with generally accepted accounting principles he should insist on appropriate revision; failing that he should add a comment in his report calling attention to the departure; further, he should consider, probably with advice of legal counsel, withholding his consent to the use of his report on the audited financial statements in the registration statement."

SAP 47 states that an accountant should insist on "appropriate revision." It does not specifically state that he should notify the SEC or stockholders. If the commissioner prevails in NSM, he will thus expand the responsibilities of the auditors. The courts are again urged to take auditing practice a step beyond that dictated by the standards currently pronounced by the members of the profession.

Concluding Remarks

It may be small comfort—but then at least some—for the accounting profession in the United States to note that they are not alone in their trial of fire. The UK cases of *Candler v. Crane, Christmas & Co.* and *Hedley Byrne & Co.. Ltd. v. Heller and Partners, Ltd.* were cited by Mr. Sommer.

In the December 1971 *Abacus*, W. P. Birkett and R. B. Walker describe major Australian company failures of the past two decades, including the Reid Murray group, and discuss the resulting lawsuits. They conclude "Perhaps more than any other factor, company failures have tested accountants' claims to professional status, their capacity to respond to criticism, the quality of their organization and the rationale of their various practices."[3]

Nor have our Canadian neighbors been without their cases. In the May 1971 *Canadian Chartered Accountant* William A. Farlinger concludes in the Atlantic Acceptance Corporation case that although Atlantic's failure resulted in

some large losses, those who suffered them were able to afford it.[4] On the other hand, Atlantic has stimulated better financial information for investors.

What are the implications of these cases?

First, it seems highly probable that business for attorneys in the liability area will increase throughout the 1970's.

Second, some major auditing firms will suffer painful consequences, in the short run.

Third, the 1970's lawsuits—like McKesson-Robbins—will result in further extensions of auditing practices that will increase the prestige and importance of the auditing profession in the long run.

Footnotes

1. Civil Action No. 225-72, United States District Court for the District of Columbia, February 3, 1972.
2. *The Journal of Accountancy,* March 1972, page 13.
3. W. P. Birkett and R. G. Walker, "Response of the Australian Accounting Profession to Company Failures in the 1960's," *Abacus,* December 1971, pp. 97-136.
4. William A. Farlinger, "Atlantic Acceptance—Calamity or Catalyst?," *Canadian Chartered Accountant,* May 1971, pp. 339-343.

3

Toward Standards for Statistical Sampling

Kenneth W. Stringer
Haskins & Sells

I am always glad to have an opportunity to discuss statistical sampling, which is one of my favorite subjects. I am particularly pleased to be able to do so at the invitation of Howard Stettler because my interest in the subject was first stimulated by reading his article in *The Journal of Accountancy* in January 1954. At that point I became convinced that statistical sampling is the most rational means for determining the extent of audit tests of details of transactions and account balances. Extensive study and experience in implementation of statistical sampling in our Firm's audit practice in the intervening years has strengthened that conviction.

Although the use of statistical sampling in the profession has not progressed as rapidly as I have considered desirable, I think it is fair to say that interest in the subject is increasing currently. This observation is based on discussions with interested parties in various firms concerning the extent of their current studies and/or applications. The reasons why progress in the meantime has been more evolutionary than revolutionary are understandable, and have involved both statistical and auditing problems. The statistical problems have included the general unfamiliarity of auditors with statistical methods, and technical questions concerning the applicability of certain statistical methods to auditing situations. The auditing problems have related primarily to defining and expressing audit objectives in terms susceptible to statistical measurement, and to the difficulty of combining statistical and subjective evaluations of audit evidence in forming overall conclusions.

Because the auditing problems are equally or more difficult and also are more appropriate for my assigned topic, I will confine my discussion today to them. For this purpose I will review first the evolution of present AICPA literature concerning statistical sampling, and second the current consideration being given to the expansion of that literature.

Present Literature

The first official AICPA literature on statistical sampling was a special report of its Committee on Statistical Sampling, which was published in *The Journal of Accountancy* in February 1962. Although this report was quite general in its coverage, it was the result of extensive deliberations by the Committee and established two landmark positions. First, it stated that:

> The Committee is of the opinion that the use of statistical sampling is permitted under generally accepted auditing standards.

The second position was expressed as follows:

> Although statistical sampling furnishes the auditor a measure of precision and reliability, statistical techniques do not define for the auditor the values of each required to provide audit satisfaction.
>
> Specification of the precision and reliability necessary in a given test is an auditing function and must be based upon judgment in the same way as is the decision as to audit satisfaction required when statistical sampling is not used.

The next reference to statistical sampling in AICPA literature was in Statement on Auditing Procedure No. 33, issued in December 1963, which included the following comment:

> In determining the extent of a particular audit test and the method of selecting items to be examined, the auditor might consider using statistical sampling techniques which have been found to be advantageous in certain instances. The use of statistical sampling does not reduce the use of judgment by the auditor but provides certain statistical measurements as to the results of audit tests, which measurements may not otherwise be available.

The use of expressions such as "might consider using" and "statistical measurements . . . which . . . *may not* otherwise be available" (emphasis added) suggests that the Committee on Auditing Procedure was perhaps neither as enthusiastic nor as knowledgable as the Sampling Committee. However, the foregoing excerpt did represent an advance in authoritative recognition because the Committee on Auditing Procedure is senior to the Committee on Statistical Sampling in the AICPA committee structure.

The next pronouncement was a report by the Committee on Statistical Sampling that appeared in *The Journal of Accountancy* in July 1964.

In line with the position taken in the preceding pronouncements, that report stated that the use of statistical sampling ". . . is permissive rather than mandatory under generally accepted auditing standards."

As indicated in the introduction of that report, it was issued:

> . . . to discuss more specifically a way in which statistical precision and reliability can be related to generally accepted auditing standards and to point out some of the factors to be considered by the auditor in deciding what degree or level of each is satisfactory for a particular sample; it is not issued to propose definitive numerical criteria for these measurements nor to discuss their mathematical aspects.

The purpose as stated in this excerpt was in response to some of the principal questions that were being discussed among those interested in statistical sampling at that time. For example, there were differing views as to what auditing considerations were relevant to precision and reliability, respectively, and as to whether—and if so how—internal control should be considered.

As to the first of the questions referred to above, the Committee stated that:

> Although "precision" and "reliability" are statistically inseparable,

> the Committee believes that one of the ways in which these measurements can be usefully adapted to the auditor's purposes is by relating precision to materiality and reliability to the reasonableness of the basis for this opinion.

Further discussion of this concept and its relation to internal control will be presented later in this paper.

The next AICPA pronouncement involving statistical sampling was Statement on Auditing Procedure No. 36 issued in August 1966 by the Committee on Auditing Procedure. This Statement was concerned primarily with the auditing implications of the use of statistical sampling by clients in lieu of taking complete physical inventories. Pertinent excerpts from this Statement follow:

> In recent years some companies have developed inventory controls or methods of determining inventories, including statistical sampling, of sufficient reliability to make an annual physical count of each item of inventory unnecessary in certain instances. The purpose of this Statement is to recognize this development. . . . If statistical sampling methods are used by the client in the taking of the physical inventory, the independent auditor must be satisfied that the sampling plan has statistical validity, that it has been properly applied, and that the resulting precision and reliability, as defined statistically, are reasonable in the circumstances.

The latest stage in evolution of the AICPA's position concerning statistical sampling did not result in the issuance of a pronouncement, but I believe it was equally significant. One of the recent projects of the Committee on Statistical Sampling was to reconsider the July 1964 report, and after extended study the Committee concluded that no revision was necessary.

Pronouncement under Consideration

One of the major projects currently on the agenda of the AICPA Committee on Auditing Procedure is a comprehensive statement concerning internal control. The present draft of the proposed statement includes a revised definition of internal accounting control and a discussion of basic concepts implicit in such definition. It also includes discussion of the review, tests, and evaluation of internal accounting control required by the second generally accepted auditing standard of field work, and of the correlation of such evaluation with the other auditing procedures as contemplated by the third standard of field work. The proposed statement was originally intended to deal also with reporting on internal control, but the Committee decided to accelerate its pronouncement on this aspect of the subject and did so by the issuance of Statement on Auditing Procedure No. 49 in November 1971.

Because of the obvious applicability of statistical sampling to tests of compliance with internal control under the second standard and to the sufficiency of evidential matter under the third standard, the earlier drafts of the proposed statement included some discussion of these matters. However, in deference to the view of some committee members that any extended discussion of statistical sampling in the text of the proposed statement would give it a degree of prominence incompatible with its permissive status, such discussion has been relegated

to appendices in the more recent drafts. Because of the subject matter involved the AICPA Committee on Statistical Sampling has assisted by reviewing and commenting on the drafts of the appendices.

In order to comply fully with our professional standards of reporting, I want to express an unequivocal "disclaimer of opinion" as to the extent, if any, to which the presently proposed appendices on statistical sampling will be included in any statement issued by the Committee on Auditing Procedure. However, since the word "toward" in my assigned topic implies movement in the direction of standards and not necessarily their attainment, I believe it is appropriate to discuss the purpose and nature of the proposed appendices. The present draft of the proposed Statement on Auditing Procedure includes an Appendix A and an Appendix B.

Appendix A is the July 1964 report of the Committee on Statistical Sampling, which was referred to earlier. This report would be included because of its general conceptual relevance, and to provide background for Appendix B.

The purpose of Appendix B would be to amplify certain of the concepts in Appendix A and to provide quantitative criteria or guidelines for their application in practice. Such criteria were not considered timely when the 1964 report was issued, but they have been included in the draft of Appendix B on the premise that the intervening years of education, experience, and changing audit environment have made their inclusion appropriate at this time. In making this statement, I should confess my personal bias and reiterate my earlier disclaimer as to the eventual decision of the Committee.

The proposed Appendix B discusses criteria for reliability and precision for tests of compliance with internal control, and also for substantive tests as to the validity and the propriety of the accounting treatment of transactions and balances. Although compliance tests and substantive tests are discussed separately in the proposed Appendix because of the separate considerations relevant to each, the draft recognizes that a single sample can be designed to serve both of these purposes simultaneously.

Compliance Tests. The objective of compliance tests is to obtain evidence of compliance with, or conversely, of deviations from procedures the auditor considers critical for purposes of his evaluation of a particular aspect of internal control being tested. Samples designed for this purpose should be evaluated in terms of deviations from such procedures, either as to the number of such deviations or the monetary amount of the transactions on which the deviations occurred.

For compliance tests, the present drafts suggest a reliability level of 95% with reference to the upper precision limit related to the estimated internal control deviations. The draft also suggests that an upper precision limit of 5% with respect to internal control deviations would provide satisfactory evidence of compliance to justify maximum reliance on internal control in performing substantive tests, as discussed later. If the upper precision limit exceeds 5%, the draft suggests that reliance should be reduced accordingly. In developing this position, the draft points out that although internal control deviations increase the risk of errors in the accounting records, such errors do not necessarily follow from the deviations. Deviations from internal control procedures would result in errors at the same occurrence rate in the accounting records to be audited only if such deviations and the actual errors occurred on the same transactions. Conse-

quently, internal control deviations of as much as 5% of the number or amount of transactions rarely would be expected to result in errors of that magnitude in the accounting records being audited.

Substantive Tests. In the proposed Appendix, all auditing procedures other than compliance tests are referred to as substantive tests, and the feature of audit interest in performing such tests is considered to be the monetary amount of any errors that would affect the financial statements being audited. It should be noted that this definition of substantive tests includes both tests of details, which are susceptible to the use of statistical sampling, and other types of auditing procedures, which are not.

As indicated above, the proposed Appendix suggests a single reliability level for compliance tests. This was considered appropriate for such tests because the evidence obtained from them is the primary source of the auditor's reliance with respect to compliance with internal control procedures. This is not the case, however, in considering the reliability level for substantive tests, because the reliance on the latter is to be combined with the reliance on internal control in forming the auditor's final opinion on the financial statements. This concept was expressed in the July 1964 report as follows:

> These standards [the second and third standards of field work] taken together imply that the combination of the auditor's reliance on internal control and on his auditing procedures should provide a reasonable basis for his opinion in all cases, although the portion of reliance derived from the respective sources may properly vary between cases. For statistical samples designed to test the validity or bona fides of accounting data and to be evaluated in monetary terms, the committee believes the foregoing concept should be applied by specifying reliability levels that vary inversely with the subjective reliance assigned to internal control and to any other auditing procedures or conditions relating to the particular matters to be tested by such samples.

The foregoing reference to "subjective reliance assigned to internal control" introduces an important element on which judgment is required. The proposed appendix would express the Committee's judgment in this respect by establishing a range of reliability levels to be used where statistical sampling is utilized in conjunction with the auditor's principal substantive tests.

The upper limit for this range would apply where the auditor's evaluation indicates that little if any reliance should be assigned to internal control, and the present draft suggests that a 95% reliability level is reasonable in such circumstances.

Establishing the lower limit for the range of reliability factors for substantive tests is more difficult. If the auditor's evaluation of internal control indicates that both the prescribed procedures and the degree of compliance with them are satisfactory, the extreme position would be to assign all of the desired reliance to internal control and require none from other auditing procedures. This would be tantamount to setting the lower limit for reliability levels for substantive tests at zero. The draft rejects this extreme, however, on the grounds that generally accepted auditing standards contemplate that substantive tests will be restricted, but not eliminated, through reliance on internal control. This position recognizes that the maximum potential effectiveness of internal control is

something less than complete because of the inherent limitations in any such system.

These limitations arise from such causes as misunderstandings, carelessness, distraction, fatigue, mistakes of judgment, dishonesty, or collusion, all of which relate primarily to the potential behavioral characteristics of individuals. The auditor ordinarily has little if any basis for making a realistic judgment as to the likelihood that such behavior will occur in individual situations. Accordingly, the draft suggests that a limit as to the maximum reliance to be assigned to internal control based on the collective judgment of the Committee would be useful for guidance to auditors in practice.

The risks to be considered for this purpose were described in the July 1964 report as follows:

> The ultimate risk against which the auditor and those who rely on his opinion require reasonable protection is a combination of two separate risks. The first of these is that material errors will occur in the accounting process by which the financial statements are developed. The second is that any material errors that occur will not be detected in the auditor's examination.
>
> The auditor relies on internal control to reduce the first risk and on his tests of details and his other auditing procedures to reduce the second.

In mathematical terms the excerpt quoted above describes a conditional probability, because the second of the adverse events referred to cannot occur unless the first has occurred also. Therefore, the combined risk of both of the related events occurring jointly is the product of the respective risks of their occurring individually. This concept is illustrated numerically in a tabulation that follows after brief comments concerning the nature of the respective risks.

The magnitude of the inherent risk of occurrence of material errors in the absence of satisfactory internal control is unknown, but experience indicates that this risk is moderate. Although this risk is an unknown quantity, it may be dealt with as such in the illustration that follows by simply designating it as "X."

The reliance that should be assigned to satisfactory internal control is the portion of the risk of occurrence that may reasonably be expected to be eliminated by such control, while the residual risk of occurrence is the portion reasonably attributable to the inherent limitations on internal control.

The risk arising from sampling and other auditing procedures (and the complementary reliability) is that which is required to establish the combined audit risk at a specified level. (These risks exclude the risk of any non-sampling errors and any similar errors relating to other auditing procedures.) Since the risk from sampling and other auditing procedures may include both of these elements, the concept being discussed here is broad enough to comprehend quantification of the latter also. I believe there is a reasonable basis for such quantification in many cases, but this is beyond the scope of the proposed Appendix B and of this paper. In both, the discussion of sampling reliability levels applies only to cases in which a sample is the principal element in the auditor's substantive tests of a particular aspect of the transactions or balances comprising the population.

Subject to the preceding comments concerning respective risks the following

tabulation shows for several assumed levels of reliance on internal control, the resulting risk and reliability that will provide an assumed uniform combined risk:

Inherent Risk of Occurrence Of Errors	Reliance Assigned to Internal Control	Residual Risk of Occurrence Of Errors	Risk from Sampling and Other Procedures	Combined Audit Risk	Reliability from Sampling and Other Procedures
X	.00X	1.00X	.05	.05X	.95
X	.50X	.50X	.10	.05X	.90
X	.75X	.25X	.20	.05X	.80
X	.80X	.20X	.25	.05X	.75
X	.85X	.15X	.33	.05X	.67
X	.90X	.10X	.50	.05X	.50

Any presentation of a mathematical model in which subjective judgments and objective measurements are combined invites the somewhat annoying, but nevertheless completely accurate, criticism that the former cannot be quantified precisely. This criticism, however, does not impugn the usefulness of a model in focusing attention on the separate elements of a complex problem, and in showing the relationship between those elements. Furthermore, this criticism invites the rebuttal that it is more rational to quantify some of the separate elements of a problem, subjectively if necessary, than to deal subjectively with the entire set of elements where some can be measured objectively.

If this analytic approach is accepted, the following two observations about the tabulation presented may be helpful in considering it. First, auditors' experience and understanding of the potential and the limitations of internal control makes it more realistic for them to exercise professional judgment in deciding in the framework of that model what reliance should reasonably be assigned to internal control, than in deciding in the abstract what sampling reliability level should be used. Second, although the inherent risk "X" is unknown, experience shows clearly that it is substantially less than 100% and consequently the combined risk ".05X" is substantially less than 5% of all audit populations sampled.

The present draft of Appendix B provides for but has not yet proposed the reliability level to be used for substantive tests where internal control is considered satisfactory.

As to precision limits for substantive tests, the present draft of the proposed Appendix B accepts the concept that these should be based on the auditor's judgment concerning materiality in relation to the financial statements and it does not propose any further guidelines in this respect.

The determination of reliability levels and precision limits is the vital interface between the subjectivity of auditing judgment and the objectivity of statistical sampling. I believe the concepts discussed in this paper are sound in theory and workable in practice. I hope they will become steps—in the words of my assigned topic—"toward standards for statistical sampling."

Discussant's Response to Toward Standards for Statistical Sampling

James W. Kelley
University of Georgia

As was expected, Ken Stringer expertly reviewed the brief history of the move toward establishing standards for the use of statistical sampling in auditing. He has also analyzed the situation and referred to specific proposed standards.

His analysis and the recommendations have far reaching implications and are deserving of our most serious attention and discussion. The purpose of this paper is to direct further attention to some of what I hope will prove to be the more serious implications of establishing standards.

Are Standards Needed?

Several years ago over a hundred of us attended a Professional Development Workshop on the use of computers. We spent two full days working on controls over commission checks sent to some independent salesmen. Near the end of the program one of the most inexperienced men in attendance said with absolute innocence, "I don't see why we can't have the salesmen deduct his commission as he sends in the order. Then we wouldn't have to send these checks." You know, he was right. Over 1500 man hours were spent working on a problem that really didn't exist.

This is not to say we have no problem, but we do hear a lot of conversation on what standards are needed and very little on why they are needed. We also hear some recommendations about what the standards should say but almost nothing can be found about what they will mean.

Let us remember first, that all statistical theory can do for the auditor is state in mathematical terms the risk he is taking by not examining all items. Statistical sampling can not tell us what tests are to be performed or what evidence need be collected to satisfy the test. It deals only with the sample size.

It should be understood that the courts have never ruled on the use of statistical sampling in auditing. A lawyer friend of mine recently searched the reported cases involving accountants and found no references to statistics. There was a by-product to this research, however, that surprised me. He found no cases where the auditor's sample size was questioned. I understand the attorneys of a national accounting firm conducted the same type of study with the same results. This suggests that, to date, the courts have not questioned auditors' judgments on sample sizes. While we may properly decide that standards are necessary, there appears to be no overpowering legal reason to do so just now.

It is argued by some that we need to set standards before someone else does. This is a powerful argument, with both rational and, in the light of recent de-

velopments within the realm of accounting practice, strong emotional appeal. This argument would be persuasive even if one feels there is no immediate danger of the courts setting guidelines, unless there are good reasons not to have standards. Are there such reasons?

Suppose we do establish guidelines (standards) for setting confidence levels and precision. Now assume a firm chooses a judgment sample and in retrospect, the judgment sample result proves not to meet the statistical standards imposed by the guidelines. Would such a firm be held guilty of violating the evidence standard? One attorney who reviewed these hypothetical facts is certain they would be.

There are also cases in which firms select sample sizes based on judgment but draw random samples. These firms do not statistically evaluate their results, but anyone gaining access to their findings clearly could. In those cases, where the established standards are not met, there is absolutely no doubt, again in one attorney's opinion, that the firm could be successfully accused of failing to comply with Generally Accepted Auditing Standards.

Perhaps now is the time to establish standards regarding the size of audit samples, but we should recognize that established standards for statistical sampling will likely be the benchmark that all samples can be measured against. The dilemma here is a real one. If we fail to enact standards for statistical testing the courts may well do so. If we do enact them we will, for the first time, give the courts a specific basis for questioning all sample sizes. Auditors using statistical sampling will no doubt push hard for standards. Since my bias is with them, I cast a somewhat timid vote to proceed.

Standards for Compliance Tests

The proposed standard suggests a reliability level of 95% with an upper precision limit of 5%. How would such a standard be applied? First we must decide 5% of what. Mr. Stringer suggests that compliance tests are performed to determine the extent of critical errors affecting the evaluation of the internal control aspect being tested.

Assume we are testing the voucher support for cancelled checks. The system calls for a purchase requisition, receiving report and invoice to back up each check. How would the standard apply?

There are many questions we could raise but a few should make the point. Will the 5% refer to the number of errors or the dollar amount? Will the 5% apply to purchase requisitions if 5% is proper for invoices? How will we account for missing documents?

The questions posed here may not be monumental but they do suggest that auditors do not agree on what is being tested and what standard is to be used to test compliance. The questions also suggest that auditors will not agree on how errors should be defined, let alone what makes an error critical. In short, in my judgment, we will not be able to get agreement on any compliance test standards in the near future. Since setting a precision standard for compliance tests is not necessarily essential, I would hate to see us spin our wheels in these largely semantic arguments while more important issues go unattended.

This position must not be interpreted as opposing the use of statistical sampling in compliance testing, for the opposite is true. The point here is that the

profession is not agreed as to what types of tests are needed. Any serious attempt to standardize sample sizes in the face of such disagreement will create more problems than it will solve. For one thing, it may well keep us from arriving at standards relative to substantive tests. Standards for substantive tests are both possible and very desirable.

Relationship of Internal Control to Substantive Tests

There is general agreement that the extent of the substantive tests is somehow inversely related to the reliance placed on internal controls. There are floating around in published and unpublished articles as well as in private correspondence, mathematical models aimed at measuring this relationship. Mr. Stringer presents one in his paper. As he points out, it is annoying but accurate that the subjective judgments necessary cannot be quantified precisely. What he didn't say was that because they can't be defended they also can not be proven wrong. Therefore, many of us, secure in the knowledge that we can be inventive but not proven wrong, have bitten into the apple of temptation and developed our own models. One of Parkinson's laws surely applies here because the newer models are much more mathematically complex. One of the unexplained phenomena of our time is our insistent belief that we can improve our assumptions by chi-squaring, coefficient variationing or plotting them on a curve. In any event the results of these various models turn out to be about the same.

The problem of precision is easily disposed of. Precision is related to materiality and since there is always a committee working on a definition of materiality we can defer further discussion of that topic until their report is available—or at least until that topic is covered in the program tomorrow. That leaves the proper confidence level as the only bone of contention. A 95% level usually is the ceiling, based more on economic necessity than on mathematical analysis I suspect, but the result is a reasonable one. When we do set standards regarding the extent of the substantive tests required, the 95% figure probably will be adopted as the maximum needed when internal controls are weak. What the level should be when the auditor has maximum faith in internal control is harder to agree on. Mr. Stringer's 50% suggestion equals the lowest I've seen, but it does not differ enough from the answer obtained using my own unsophisticated approach to warrant any further comment. Since Mr. Stringer has, as a member, courageously predicted what the Committee on Auditing Procedure *might* do, I'll predict with equal fortitude that the Committee on Statistical Sampling *could* recommend the confidence level at 95% when internal controls are not relied on, and around 65% when controls are proven strong. (Precision will be related to materiality with materiality remaining undefined.)

Are Compliance Tests Required?

The standards of field work require a proper study and evaluation of internal control as a basis for reliance thereon and for the determination of the resultant extent to which tests of the accounting procedures are to be restricted. If the 95% limit is enacted, there will be some interesting ramifications in audit strategy.

The study of internal control is taken to mean that the auditor must familiar-

ize himself with the workings of the client's system. This study is documented by completion of internal control questionnaires, and flow charts or narrative descriptions. On completing this study, the auditor must subjectively decide if he would rely on the output *assuming* the system is working as designed.

He may decide he can not rely on the system's output. The system may be improperly designed or management may be able to render the controls ineffective. If the auditor does not plan to rely on the system, then there is no reason for him to determine if the system is working.

On the other hand, often the auditor senses that the system is capable of producing accurate data. In these situations, he must test the system extensively enough to satisfy his subjective judgment that the controls are working or are not working.

If the controls are working, he may decrease the substantive tests at a lower confidence level. If the controls are not working, he must use a 95% confidence level. Now even limited experience using statistical techniques will show that proving the controls are working may be very time consuming and expensive. When the population error rate is close to the maximum rate acceptable to the auditor, extremely large samples are necessary. If the auditor tests attributes and sets a maximum error rate of 5% at 95% confidence and the actual error rate is 4%, a sample size of 1,000 is needed. Thus, we can expect cases where the auditor will use less time by increasing his substantive tests than it takes to accumulate enough evidence to support reliance on the controls. The auditor in these situations will recognize that even if the controls could be proven reliable it would be wise not to rely on internal control but to expand the year-end work to the maximum.

I do not want to create the impression that reliance on internal control is doomed, or even wrong, but the adoption of the above approach will lead people to rely on internal controls only when it is expedient to do so.

While the auditor will still be required to review internal control in the sense that he must clearly understand how the client goes about his business, the compliance tests will be optional. The tests would only be required when the auditor plans to use a confidence level of less than 95% in his substantive testing.

Such a proposal has caused some eyebrow-lifting among some of my colleagues but seems entirely consistent with both the proposed statistical standard and generally accepted auditing standards.

There is one final consideration in the application of this standard that should also be mentioned. Even if one agrees that 95% confidence is satisfactory to accept a client's representation, he may not agree that 95% confidence is high enough to support an adjusting entry. An example here may help. The client shows an inventory balance of $95,000. The auditor concludes his tests and estimates the inventory balance to be $98,000 with a precision of ± $5,000 at 95% confidence ($10,000 is considered material).

The auditor is 95% certain the audited balance would be between $93,000 and $103,000. He also believes that any balance within that range will result in a fair presentation. Since the client's representation is within the range of acceptable balances, the auditor in accepting the client's statement will have met the standard.

Now assume another situation in which the auditor estimates the total

audited value to be $98,000. Again he is 95% confident that if he audited all the items the audited balance would be somewhere between $93,000 and $103,000, but in this case the client's balance is $125,000. Clearly the evidence indicates the auditor should not accept the client's representation. But what can he do?

The auditor is left with three alternatives. I am reminded here of Bob Uecker's classic work entitled "How to Catch a Knuckle Ball." Chapter I states there are three recommended methods of catching a knuckle ball. Chapter II says none of them work. The auditor is in a similar position here, but he must do something.

(1) He could return the materials to the client for reworking and resubmission.

(2) He could increase his sample and thus identify more specific misstatements in the client's data. As the client adjusts for those errors discovered, he will eventually bring the balance into line.

(3) He could permit the client to book an adjusting entry to agree the account with the statistical evidence.

In our example, this would mean the client would book an adjusting entry, reducing the $125,000 total to one within the acceptable limits.

Since we accepted the client's balance earlier without relying on the system that produced it, it follows we could accept the second balance based on the same evidence. This view is consistent with those situations in which clients use statistical tests to support their own adjustments. In any case, the proposed standards should clearly indicate the extent of the evidence needed to support an adjustment as well as to accept a client's representation.

Summary

In summary, these suggestions are made:

(1) No attempt should be made at present to establish confidence level and precision statements for compliance tests.

(2) The standards clearly indicate the options available to the auditor regarding compliance testing.

(3) A 95% confidence level (precision related to materiality) will meet the third standard of field work when internal controls are not relied on.

(4) A 50%-60% confidence level will suffice when internal controls are proved excellent. (Precision again related to materiality.)

(5) If the client's representation is outside the limits of the auditor's statistical estimates, the auditor may accept an adjustment that brings the representation within the limits based on the statistical evidence.

The above suggestions are made assuming there is agreement that the standards will not jeopardize the position of auditors doing quality work but not using statistical techniques.

4

Future Extensions of Audit Services; Meeting Investors' Future Needs

Donald J. Bevis
Touche Ross & Co.

In a changing world, the unchanging role of the CPA is to serve the investor. Selfishly, the CPA wants to be the prime—even the only—servant of the investor. Generously, the CPA wants to serve the investor all the information he may need. A little clear thought shows that "only" and "all" are too strong. Yet the CPA is and should remain in the forefront of the campaign to provide the investor with quality information.

In our world of very rapid change, the nature of "investor information" is changing rapidly. For example, where plant capacity, production costs or sales volume were once the key factors, social values may now also be material. Although our role does not change, the data we audit and the scope of the information we examine and evaluate must change.

The Conditions of Change and Growth

For many centuries, tomorrow and yesterday were very much alike. There were few dramatic changes, and they were far between. Always, the frontier was a wilderness. There was very little difference, for example, between 1670—when the Hudson's Bay Company was formed by a group of venturers and adventurers—and 1770 when the colonies began to flex their muscle. In those times, yesterday's results were a strong predictor of tomorrow's performance. For the investor, the venturer, historical data were very significant.

Today, the great lament is that change comes so fast. We are unable to keep up, to assimilate, to digest. We wonder what will come next from the research lab, from the ecologists, from Congress, from the ghetto, via the satellite, from the moon, or from 400 fathoms. Something is coming all the time. The effect is to compress time, and for the investor, to diminish the significance of historical data. More useful data must be sought, in broader fields, and with a visionary eye.

In the days of the Hudson's Bay Company, entrepreneurs banded together in joint ventures to capitalize on opportunities in strange, new, faraway places. When the venture was completed, the manager called a meeting to report to the venturers. Usually his report was oral, and the venturers had an opportunity to ask questions and interrogate the venture manager and the exploring team. By experience, the investors found that these review meetings were more suc-

cessful if they brought along their own expert, an experienced businessman who had no vested interest in that particular venture, to listen to the manager's presentation and to challenge unreasonable assertions. The venturers were interested in the results of the completed voyage, of course; they also needed an understanding of management's performance so that they could make reinvestment decisions intelligently.

From these early beginnings came the auditing profession of today. The objective and critical independence which made the auditor valuable to the investing public during the time of colonial exploration is of even more value today. Absentee owners still need an independent, objective, informed opinion about their investments. Today, the owner is more detached than ever from the activity in which he invests. The detachment of the investor, the complexity of business today, and the trend from laissez faire to consumerism have heightened the need for reliable decision making information—decision making information independently attested.

As the investing public demanded better decision making information, the profession responded. We might argue about how successful the response has been, but there should be no argument that the need has been evident, the profession has recognized the need, and an effort has been made to meet that need.

> We now take it for granted that a publicly-held business will prepare an annual financial statement. It has not always been so, however. The investing public is demanding more timely information and it's clear that interim reporting is taking on additional importance. It's safe to predict that eventually quarterly financial statements will be as routine as the present annual report.
>
> **Accounting Trends and Techniques** now reports that all companies in its sample provide sales information. Many in the profession will remember that the issue of sales disclosure was so controversial that it was viewed as the final cut which if insisted upon would alienate the accountants from the business community. Today, however, many companies are experimenting with segmented reporting of sales and profit contributions.
>
> Today, we are grappling with quantifying complexities such as leases and option plans. These studies are also controversial, but the investor has made it clear that there must be a better way to communicate than by complex, obscure footnotes.

Each new development in public reporting brought with it cries of anguish from those who could only see potential dangers. Public pressure, however, has overcome that resistance and with the help of the profession, the investor today has more reliable, more useful decision making information than ever before.

But, considering the changing, complex world today, is the investor really informed? Does he have more information, relatively, than the venturer who invested in the Hudson's Bay Company?

Public Forecasting Is the Next Step

It has become increasingly clear that the investing public is dissatisfied with simple, historical data. The public is saying that they need more information

about the future prospects for a business. Based on past developments in financial reporting, it seems safe to predict that the investors will be given what they demand.

It has long been acknowledged that the public investor tends to use the classic, historical financial statement as an indication of the company's future prospects. The market price of a stock is influenced by many factors, but even the most uninitiated investor recognizes that a major influence is a company's prospects for future earnings growth. Analysts use the historical financial statements as the basis for their projections, adjusting prior years' performance for predicted variations in the economy and the industry. Individual investors follow trend lines and tend to make assumptions about the future based on the company's past performance. But in all too many cases investors find these history-based trends to be inadequate and turn to rumor and speculation to make their decisions about the future.

The investing public is hungry for profit—and therefore for information about a company's prospects. Whether we like it or not, decisions *will* be made based on forecast data. The decisions *will* be made whether the forecast data are reliable or not.

The SEC had long taken the position that a company may not talk about its prospects for the future when it is in registration. However, the SEC is taking another look at that policy, and has stated that factual information should always be timely given. And in a recent speech, the Chairman of the SEC suggested it might be appropriate to experiment with forecast information in a prospectus. The Commission has apparently concluded that the investor should have formalized, controlled forecast data rather than relying on street talk.

In England, the City of London Code requires an accountant's report on any projection of operating results included in a takeover or merger proposal. John P. Grenside, writing in *The Journal of Accountancy*, said, "It is indeed difficult to see how shareholders can form a judgment as to the value of their shares or the merits of the [takeover] offer without this [profit forecast] information, particularly when a significant change in a company's fortunes is expected."[1]

In a speech before the Chicago Chapter of the Planning Executives Institute in January, 1972, Dean Sidney Davidson of the University of Chicago Graduate School of Business, predicted that within five years publicly held companies would be including forecast data with their regular annual reports. Dean Davidson said "It is not a question of *if*, it is simply a question *when* and in what form."

The financial analysts have concluded that public companies must give the investing public more information about their prospects—and do it in a more structured way. At the Seaview Symposium in November of 1971, the analysts expressed their concern that a company avoid surprises in the market place. In that context, it was concluded, "Among the participants the analysts seemed generally in agreement that public forecasting was an idea whose time had come."[2]

The trend seems abundantly clear. The investing public will demand information about the future potential of their investments and that demand will be met. It also seems clear that the profession must anticipate that demand and be prepared to meet the public need in the most productive way.

Forecasting Defined

Before we pursue this subject further, it will be helpful to define our terms.

Forecasting is a broad term, and it encompasses many different levels of predictive information—micro and macro, internal and external. Let us agree, for instance, that a feasibility study to determine whether to expand the plant or whether to buy a component from a supplier or manfacture it ourselves is one form of forecast. Investment analysts estimate earnings per share information for many publicly traded companies, and this data too can be considered to be forecast data. Some consumer oriented companies publish actual and projected information about their industry. For our purposes, these industry projections still can be considered forecast data even though the investor must make his own assumptions about market share and product costs to convert this broad economic information into a measure of a company's operating prospects. Finally, most well managed companies prepare a profit plan to guide them in their current decisions. That profit plan is technically a budget, but for the purpose of this paper, we will consider it to be a part of the family of forecast data.

Reporting Forecast Data to the Public

What kind of forecast information should be made available to the investing public? Since we are on the threshold of a new accounting concept, perhaps we can take a new approach to the kinds of information to be made available. Perhaps we can avoid some of the problems we have had with traditional financial statements. Traditional historical statements have grown like Topsy; perhaps we can anticipate the need for forecasting information and shape its development rather than follow its evolution.

It would be a mistake to insist on one format for forecast data from all companies. The kind of information provided should vary, depending on such circumstances as the quality of information available, the degree of certainty related to the assumptions, and the company's track record.

The long-established, stable company, such as a public utility, might well present comparative earnings information: last year, this year and next year. Ideally, such an earnings statement should show last year's projections for the current year, this year's actual results, and next year's forecast. This presentation would be appropriate for most stable companies because their products are accepted, they can look to their own sales experience as well as reliable external information to forecast volume, and their management experience gives them a clearer understanding of their company's volume—cost relationship.

At the other extreme, a new development company, formed to exploit an idea, should not try to provide that kind of comprehensive information. Instead, they should make available all reliable component information. What are product costs expected to be at various sales levels? What are the results of market research studies? What factors might influence the company's sales success? For many companies in the development stage, it would be inappropriate to prepare a comprehensive earnings forecast because there are simply too many variables. Those variables do not excuse a company from publishing the information it has available, however. The investor must recognize that his investment in a development stage company carries greater risks than his investment in the long-time, stable company. The investor will assemble his own forecast for the development company—*he is doing so today*, but he must be given all of the reliable information that is available.

In between these two extremes, the stable company and the development company, different kinds of presentation will be required. For most companies, the single, most important variable in their forecast is product sales. It may be appropriate to present several earnings projections based on different sales assumptions, making appropriate cost adjustments because of the different volume projections. The text of the forecast should describe the sales assumptions and relate them to the company's prior experience and to that predictive information which is available about the industry or the economy as a whole.

In any situation, the assumptions underlying the forecast data must be clearly spelled out. All significant assumptions should be disclosed; "significant" in this context should be related to the significance of the assumptions to the reader's understanding of the forecast data and the degree of certainty or risk associated with the forecast.

Auditing a Published Forecast

It seems apparent that the public investor will demand and will be given forecasting information. It also seems apparent that the public will insist on some form of attestation on the forecast data. The outside stockholder has felt the need of an objective, independent comment on the representations of management as expressed in historical financial statements. It seems reasonable to expect that management representations about forecast data will become critical to investment decisions, and as they increase in importance, independent attestation will be required.

Ijiri says ". . . usefulness of budget disclosure to stockholders and other investors is unquestionable. Implementation of budget disclosure must be supported by effective budget auditing in order to insure the reliability of the budgets."[3]

Nurnberg agrees, "It seems apparent that budgets will be published eventually . . . and once budgets are published, auditors will be called upon to attest to them. The attest function will be extended to budgets as the need for attestation is demonstrated."[4]

Our English counterparts experienced this evolving demand. Originally, the City Code required that in any proposed merger or takeover, the directors were to prepare forecast information and the accountants were to act as advisors and consultants to see that the forecast data was prepared with due care. The accountants agreed to report on their study of the forecast data and to make their reports available to the City Panel but not to the public stockholders. This proved to be an untenable situation:

> The public knew that the accountants had issued a report on the forecast and they were exerting pressure to have that information made available.
>
> Company management took the position that they had paid substantial sums to have the auditors participate and they ought to be able to make the auditors' report public information.
>
> If an auditor had some reservation about forecast material prepared by a company, he found it very difficult to make his reservations known when he was precluded from publishing his report.

Mr. Grenside reports, "There were thus obvious and increasing difficulties in the application in practice of the Institute's advice that reporting accountants should not permit their names to be directly associated with profit forecasts and there was pressure for the accountancy bodies to reconsider their position."[5] After much soul searching and negotiation, the accountants and the City authorities agreed that the accountant's report, covering the accounting basis and calculations for the forecast, would be published and the accountant would formally consent to (or deny) the use of his report in the merger documents.

The public accounting profession is in a unique position to meet the need for audited forecast information. In the area of historical financial reporting, the profession has established a reputation for independence and objectivity. The investing community also accepts as fact that the CPA is a prudent business man, an expert in the field of accountancy and reporting and that he has thorough understanding of his client's business. These qualities—and the public recognition and acceptance of them—are necessary for effective attestation of historical *and* forecast financial data.

Standards of Performance—Auditing Forecast Data

If we accept the fact that the public accounting profession will be a part of this new accounting concept—published forecast data—it will be important to develop a framework for his participation. As a starting point, let us paraphrase the ten generally accepted auditing standards and consider how they apply to the auditing of forecast data. For some of the standards, their application will be self-evident and no further comment will be required; for some others we must expand our traditional understanding for this new application.

The General Standards

> The examination is to be performed by experienced CPAs who have training in the unique skills required for forecasting. The CPAs will conduct their examination with independence and due professional care.

Clearly the spirit of the General Standards applies to the examination of forecast data. The examination should be performed by a proficient CPA: one who is trained to gather and evaluate evidential matter; one who is trained to evaluate the fairness of presentation; one who is experienced in challenging the representations of management.

It is true, of course, that there are a number of unique skills involved in the preparation of a forecast. Companies who do internal forecasting today may use the skills of a market researcher, an economist, and an expert in cost behavior analysis. The CPA must be expected to be familiar with these unique skills in order to evaluate management's forecasting, but it's not necessary that he be a specialist in all of these fields. He must understand them so that he can be alert to possible misapplication or misuse of the procedures, but he need not have the same level of expertise as the specialist in the field any more than he need be a specialist in cost accounting, credit and collection, or electronic data processing in order to perform his traditional examination of historical financial statements.

It is understood that the CPA must proceed with an independent mental attitude. We're not talking about the independence rule which forbids him from

owning stock in his client, although the appearance of independence is certainly crucial to the public acceptance of any attestation. When we're talking about auditing a forecast, however, we're looking for the kind of independence that is demonstrated when a CPA:

> Issues a qualified opinion on historical statements even though he knows he is inviting criticism of his prior years' unqualified opinions:
>
> Insists on a certain accounting treatment because he is convinced it is right, even though there may be precedent for an alternative;
>
> Faces up to a mistake and insists on withdrawal and correction of a report which he previously certified;
>
> Proceeds on the basis that his client is the investing public.

The Standards of Field Work

> The CPA will review the procedures used by management in preparing the forecast data and will gather and evaluate such competent evidential matter as is necessary for him to formulate an opinion as to the reasonableness of the underlying assumptions and the forecast presentation.

If we're going to be involved in forecast reporting, we must go beyond the compilation stage. If we're to be associated with a forecast, we must be satisfied that the assumptions used in preparing the forecast are reasonable. Again, the experience of our English friends as reported by Grenside will be helpful:

> . . . the accountants' report is to be published, but it is to be confined to the "accounting bases and calculations for the forecast."
>
> The accountants are, however, required to give their consent to the publication of their report. This, in my opinion, imposes on the accountants an obligation to satisfy themselves as to the general reasonableness of the forecast itself and the assumptions on which it is based. If they are unable to do this, the accountants should qualify their report or, as an ultimate resort, withhold their consent to publish.[6]

In attesting to the reasonableness of the assumptions used in the forecast, the CPA will also have to be satisfied that a thorough job has been done. He will have to be satisfied that management has taken all steps that could reasonably be expected to search out those factors which might influence the forecast.

If a CPA is to form an opinion on the reasonableness of the underlying assumptions and the forecast presentation, he must have evidence in support of his opinion. It is not possible to anticipate what form the evidence might take because the circumstances in each situation will vary. However, it is reasonable to assume that the CPA will want to consider:

- published statistics from trade associations
- government information about a market segment
- specific market research studies by the company or outside consultants
- volume—cost studies prepared by the company's accounting unit.

In some cases, it may be necessary for the CPA to retain an outside consultant to assist him in his evaluations of the evidence.

As companies develop experience in public forecasting, good procedures will be codified. When a company is able to proceduralize its forecasting process, the auditor will be able to review the procedures and will report on their reasonableness and their consistent application. It is doubtful whether a new company (or one new to forecasting) will have developed a satisfactory set of forecasting procedures, and this stage of development will naturally affect the CPA's level of satisfaction. The public investor will expect audit comments on forecasting procedures, and it is reasonable to assume that he will expect improvement from management.

The Standards of Reporting

> The objective of the CPA's report is to assure the reader that the forecast information is the best available under the circumstances and that it is presented without bias, but the CPA must disclaim any opinion as to the outcome of the forecast.

In the same way that the presentation of the forecast information should vary depending on the circumstances, the attest report on forecast data must not be confined to a standard format. Today, audit reports on historical statements are either unqualified, qualified, or adverse. The traditional, historical financial statement can not be understood in "yes or no" terms, and the profession should never have allowed itself to fall into the trap of issuing a boilerplate, "yes or no" report. Forecast data is even more complex than traditional financial statements, and the attest report on forecast data must be written in such a way that the reader will read the report, evaluate all of the CPA's comments, and understand what he is trying to say. For instance, the CPA must be able to say, if necessary, that there is insufficient data available to form an opinion, without leaving an implication that management has been derelict in its duty. There will be many straight-forward, clearly legitimate situations where there will be inadequate data. The investing public must be able to understand the report, understand the nature of the risk, and act accordingly.

Each report on a forecast engagement must be a special report, written for the unique engagement. Nonetheless, it is possible to identify the key elements required in any such report:

> Identification of the data covered by the report
>
> Statement of the purpose of the forecast
>
> Reference to the underlying assumptions and an opinion on their reasonableness. (If certain assumptions are not evaluable, a statement to that effect)
>
> A disclaimer as to responsibility for the ultimate attainment of the projected results

For example, a forecast report on a real estate tax shelter program might take the following form:

> The accompanying forecast financial statements of XYZ Properties (a limited partnership) for the years 1970 through 1990, shown on pages 2 through 6, were prepared to provide estimates of cash inflow from

> partners' investments, net cash flow returned to partners, and tax consequences of projected operations to individual partners in selected income tax brackets. The forecast statements have been prepared using the assumptions and rationale set forth on pages 7 through 11.
>
> We have reviewed the assumptions and rationale underlying the forecast financial statements. We believe these assumptions and rationale are reasonable and appropriate for the purpose of this forecast.
>
> Since forecasts are based on assumptions about circumstances and events that have not yet taken place, they are subject to the variations that may arise as future operations actually occur. Accordingly, we cannot give assurance that the predicted results will actually be attained.

If the CPA has not been able to find support for the key assumptions underlying the forecast report he might use the following words:

> The accompanying statement of projected operations of the ABC Company (proposed to be formed) for the year ending June 30, 1972 was prepared on the basis of the assumptions and rationale as set forth on pages 3 through 8, to estimate what net income might be if the company were to produce a certain new line of children's toys.
>
> We have reviewed the assumptions and rationable underlying the statement of projected operations. Since there is no similar line of toys presently on the market and no marketing research has been conducted, we are unable to evaluate the reasonableness of the assumptions relating to unit volume and selling prices. All other assumptions appear reasonable and appropriate for the purpose of this projection, but since their application to the statement of projected operations is, in most cases, directly related to unit volume, the reliability of their application depends on the accuracy of the unit volume assumption.
>
> These projections are based on assumptions about future circumstances and events. We do not know the future and we cannot give assurance that the projected results will actually be attained.

It should be understood that the CPA would insist on disclosure of material conflicting evidence, or if he should conclude that the forecast data is misleading, he would withdraw from the engagement.

Forward Work

The issue is not whether forecast material will be provided to the users of financial statements, but what form will the forecast report take. The question is not whether CPAs will be asked to comment on the forecast data, but what must be done to be able to comment intelligently. There is a great deal of research to be done, and judging by the momentum behind the idea, there may not be much time. There are three specific areas which should be explored carefully in practice and in the literature:

> We must understand how the public will use forecast data when it is provided to them in an organized way.
>
> We must develop the principles to be followed in presenting forecast data.

We must study the question of a common body of knowledge for those who will work in forecasting, and bring the profession up to speed.

But What About—

There are those who say that the legal liability aspects of reporting on forecast data are so great that we can't afford to be involved. There are those who say that the investor will lose confidence in the auditor's attestation on historical statements when some of the forecast data we attest to prove to be only a reasonable man's best efforts. However, George O. May put it very well when he said, "Preoccupation with the importance of not misleading investors has obscured the desirability of enlightening them."[7]

Numbers Aren't Enough—How about Management's Performance

A CPA engaged for an examination of public forecast data finds himself in familiar territory—he will be evaluating and reporting on financial data. It has been suggested, however, than an analysis of data, historical or prospective, is a superficial way to comprehend an enterprise. It has been suggested that the only way to understand a company's prospects for the future is to understand management's ability to manage.

Within the profession there is considerable interest and debate about whether or not the CPA can appropriately give an evaluation of management. The major objections seem to be:

there are no standards for measurement of management performance.

people (management) change, conceivably rapidly, and they all have their "good" periods and "bad" periods.

It seems fair, however, to point out that it took a while to develop a base of generally accepted auditing standards, and certainly there is more to be done in the basic audit area where we feel so comfortable. You will recall that CPAs were attesting to financial statements before today's auditing standards were articulated. If the profession were not continually evolving, we would not be discussing in this symposium "Where do we go from here?"

The Hudson's Bay venturers never went exploring but they had first hand contact with their agents who did. At the completion of a voyage they had the opportunity to sign up for the next trip or look elsewhere for investment potential. They made their decision based on their experience and on their firsthand appraisal of management's skills. Today, can the investor make an intelligent appraisal of management skills? He can do so only on the basis of the company's historical performance. Tomorrow we may be able to evaluate management's ability based on their performance against a forecast. Doesn't the investor need—can't he be given—a more direct appraisal?

What Is a Management Evaluation?

Semantics give us a problem. If we are evaluating management, we are probably talking about people. If we are evaluating management systems, we are covering both people and their adopted systems in a given area. If we are

evaluating management performance, we must consider how the people performed against their systems, which also must be evaluated in terms of external standards.

We should not attempt to evaluate management except in the broadest terms—management performance. While doing less may seem to be a conservative extension of the attest function, there is a probability that stopping short is a most dangerous posture. Partial consideration of a given subject by the CPA, a professional expected (in the information user's subjective view) to assure full disclosure, will leave an implication that what is not said is satisfactory.

Where to Begin

Let us examine our recent efforts on reporting on internal control (Statement on Auditing Procedure No. 49). This pronouncement resulted because CPAs were already attesting to the adequacy of internal controls. The degrees varied, of course, from simple specification of weaknesses, to negative assurance, to a positive opinion on adequacy. The AICPA Committee on Auditing Procedure had planned to develop an SAP on the substance of internal control and the related auditor's approach, but contemporary pressures required attention to the visible problem of reporting. The result: a long, but informative, report cautioning the reader about the difficulties of measurement and concluding with what amounts to a form of negative assurance. The reception to SAP 49 has not been uniformly laudatory, particularly by government agencies, some of which suggest that it is a cutback in auditing as well as in responsibility assumed by the CPA. Change may be required in SAP 49, but when is change not required on the path of progress?

The formal entry into reporting on internal control is but a few steps removed from evaluations of management performance. If we admit that the system of internal accounting controls can be evaluated, then we will have to agree that administrative controls are similarly situated, given standards and a competent examiner. If we can address ourselves to the entire system of internal control, accounting and administrative, we should be able to evaluate the system as well as management's performance within it.

The Critical Factors

The issues of standards of evaluation and the competence of the evaluator are critical, of course. John L. Carey, in *The CPA Plans for the Future,* lists a number of possible quantitative criteria; perhaps those in which public interest was high at the time. Surely the list can be adjusted if the profession is willing to invest in the effort needed to articulate preliminary performance standards, both social and profit oriented. And there should be no misconception that there can ever be a standard for every situation. We do not have this now. A good example is the debate over whether non-arm's length transactions require no disclosure, full disclosure, or full disclosure with evaluation of the terms of the transactions—yet we continue attesting to historical financial statements nonetheless.

If we tell our attest users what we are attesting to in the area of management performance, the users will let us know what changes they want made. And the

standards will evolve in any event, through continuous consideration by the profession.

What about the CPA's competence? The major assets of the CPA are his independence, his objectivity and a thorough knowledge of his client. Even if specially engaged to evaluate management performance, the CPA has the knowledge of how to go about investigating the whole of the business, because of his usual audit approach. The use of experts from other disciplines is already common in financial auditing, particularly when major uncertainties seem to exist. There is every reason to believe this use can expand to accommodate the new criteria needing evaluation. The auditing profession will be far better off attesting to management performance under its own guidelines than being required to consider, as in historical financial auditing, performance criteria which will surely be created outside the profession.

Professors Langenderfer and Robertson believe it is feasible to perform independent management auditing.[8] Their hypotheses are considered in parallel to financial auditing postulates,[9] and they believe that the same philosophy covers both financial and management auditing. Their position would make a good starting point for serious consideration of the CPA's role in this area.

Conclusion

Historical financial information has value to an investor—to a limited degree because it is history, but more so because it has been an indicator of the future. Because of the rapid rate of change, the value of historical data as an indicator of the future has diminished. The investor needs and will somehow find other indicators of future performance. It is our responsibility to see that the investor has the best possible information. If we are to meet our time honored responsibilities in the future we must move beyond traditional practice and into the frontiers of forecasting and management evaluation. Like the voyagers of old, we must take the risk so that we may thereby best serve the needs of the public.

Footnotes

1. John P. Grenside, "Accountants' Reports on Profit Forecasts in the U.K.," *The Journal of Accountancy,* May, 1970, p. 49.
2. John C. Burton, "A Report on the Symposium on Ethics in Corporate Financial Reporting," *The Financial Executive,* January 1972, p. 30
3. Yuji Ijiri, "On Budgeting Principles and Budget-Auditing Standards," *The Accounting Review,* October 1968, p. 667.
4. Hugo Nurnberg, "The Independent Auditor's Attest Function: Its Prospects for Extension," *The New York CPA,* October 1971, p. 786.
5. Grenside, *op. cit.* p. 50.
6. *Ibid.* p. 51.
7. Paul Grady, *Memoirs and Accounting Thought of George O. May,* The Ronald Press, 1962, p. 113 (as quoted by Donald E. Stone, "The Objective of Financial Reporting in the Annual Report," *The Accounting Review,* April 1967, p. 336).
8. Harold Q. Langenderfer and Jack C. Robertson, "A Theoretical Structure for independent Audits of Management," *The Accounting Review,* October 1969, pp. 777-87.
9. R. K. Mautz and Hussein Sharaf, *The Philosophy of Auditing,* Monograph No. 6, American Accounting Association, 1961.

Discussant's Response to Future Extensions of Audit Services; Meeting Investors' Future Needs

John C. Burton
Columbia University

Historically, when I have been asked to comment on the observations of a leading member of the public accounting profession I have been in the position of saying, "Go faster; look at the potential benefits of innovation rather than emphasizing the costs and dangers." After reading Don Bevis' paper, I am happy to be able to say "three cheers!" It may even be that some of my remarks might be interpreted as urging deliberate rather than precipitous speed toward some of his well articulated objectives.

Two Principal Extensions

The paper develops two principal extensions of the attest function: reporting on forecasts and reporting on management performance. I concur that both are logical and needed. It has long been my view that the current short form report which is the auditor's principal public output represents an enormous public under-utilization of the competence of the highly talented professionals who perform audits. To render a standard report, substantial economic and human investments must be made which could logically lead to far greater and more useful public output than two standard paragraphs. This is not to belittle the importance of the attest function today, since I believe it is one of the underpinnings of our capital markets and corporate system, but simply to call attention to the opportunity costs which exist.

The paper devotes far more space to the subject of forecasting, and it develops the subject in an interesting and thoughtful manner. The discussion of auditing standards applied to forecast data and the illustration of possible audit reports on forecasts are significant contributions. They go far to indicate the conceptual feasibility of this extension of auditing within the broad framework of auditing standards today.

The second major extension discussed in the paper suggests an auditor's report on management performance, but the topic is only considered superficially. The author asserts his faith in the CPA's competence to undertake the task of evaluating management, and he incorporates by reference the article by Langenderfer and Robertson on the theoretical structure for such audits, but he does not offer any significant new insights of his own. While the fact that he supports such an extension of the auditor's function is in itself significant, one might have hoped for the same kind of new insights as to how this might be done as are found in the discussion on audits of forecasts.

Since I support fully the concepts advanced in this paper and because I largely applaud the way in which the author develops them, the rest of my comments will be devoted to some supplemental views on the topics advanced rather than specific comments relating to the paper.

Forecasts

The subject of forecasts has received great attention of late, both because of demands by investors and because of an apparent prospective change in the Securities and Exchange Commission's historical opposition to the public disclosure of forecasts in registration statements and other documents filed with the Commission. I concur with the conclusion in the paper that something is going to happen in the near future and it is important to make every effort to assure that it is the right thing.

The need for forecast data is a reflection of the fact that business is a continuum which cannot be adequately described by looking simply at history. Traditionally, history was valued for its objectivity and because it served as a basis for prediction. Recent developments have indicated that both of these qualities have perhaps been excessively attributed to financial statements to the detriment of users who accepted them on faith. Financial statements already contain many explicit forecasts, and in the face of the uncertainties of the future, it may be that our traditional single-valued format is obsolete. In addition, as Bevis points out, the world is now changing so rapidly that the predictive power of historical data is also being eroded.

An appropriate response to these developments is to expand the availability of future expectations which are being used by management to run the business, as well as possibly to adjust the traditional accounting model for "historical" financial statements. It is important, however, that in doing this, we do not create even in the short run a childlike faith on the part of users of financial statements in the forecasts which are presented. This means we must identify the uncertainties which exist and distinguish between history and projection both in forecast data and in standard financial statements.

A first step in this process would be clearly distinguishing in format between historical data and forecasts. I am troubled by Bevis' suggestion that for a stable business we could show "last year-this year-next year" data in simple columnar form. It would seem more desirable to make the "next year" data quite different in format. Perhaps we should use ranges or sensitivity analyses which analyze the relationships between data and identify the crucial variables which will affect the operations of the business in the future. It should not be the job of the Company or the auditor to furnish a simple crutch for the analyst such as next year's earnings per share. Rather, information about the business continuum—past, present and future—should be supplied in a variety of formats appropriate to the information being communicated so that improved allocation of resources in the economy can take place.

The public accountant's role in this process is twofold. First, he must be a reporting consultant who can effectively discuss with the company the types of disclosure which would be appropriate in particular circumstances. This will not simply represent the performance of a truth ritual; it will require long and

hard work to establish criteria for various kinds of data and then probably the application of personal judgment to many *ad-hoc* problems.

Second, the auditor must add reliability to the forecast data which is reported to the public. Here he must play the role of the objective, dispassionate professional. He must understand what represents good current forecasting techniques and decide whether they are in use in a particular firm. He must appraise assumptions. While he may today possess many of the skills necessary in this area, a significant increment will be required and must be developed within the profession if this function is to be performed.

There are several other problems in this extension of the audit function which must be considered and acted upon. The question of liability for error is a major one. In some fashion this must be defined. In addition, we must deal with the problems of self-fulfilling prophecies in forecasting. One of the major arguments against presenting next year's income statement is that the fact of public presentation will bias the subsequent actual figures in the direction of the forecast. If the same auditor reports on both, the problem is made more acute, although both forecast and historical data are part of the information system under audit. With sufficient quality controls in the firm, a rotation of staff and other increases in professionalism, these problems may be overcome.

Evaluation of Management

The extension of the attest function to the evaluation of management is in some ways more frightening and in others more familiar than its extension in the forecast area. Auditors have appraised internal control for many years, even though few public reports have been issued thereon and few probably will be until SAP 49 is revised. Nevertheless, appraisal of a control system in the largest sense is a form of management appraisal. The review of the system does not complete the appraisal of management but it is a starting point.

Another step may be associated with the audit of forecasts. Management itself has long used the analysis of the variances that arise between actual and forecast data as a means of appraising subordinates, and the same general approach may be applied to the top management by an outsider such as an auditor or analyst. The CPA might, for example, express an opinion as to the fairness of a company's description of the reasons for variances between historical and forecast data. This would leave the decision as to whether the variance was a management deficiency or a chance fluctuation up to the user of the statement.

It may well be that the evaluation of management will take the form of a number of specific attestations such as the ones relating to control and the explanation of variances just referred to. It seems unlikely that a single overall appraisal could be effectively presented until standards have been developed, and there are few signs that such development is imminent. A piecemeal approach therefore seems more likely. This is not inconsistent with the ideas expressed by Bevis, although he does not explicitly predict development in this fashion.

Summary

In the final analysis, I can only agree with and cheer for Don Bevis' forecast as to the extension of the attest function, even if I cannot as a CPA ethically associate my name with it in a manner which may lead to the belief that I vouch for its achievability.

5

Toward Standards for Materiality(?)

William Holmes
Peat, Marwick, Mitchell & Co.

The term "materiality" in accounting and auditing literature is variously used in relation to misrepresentation, disclosure, segregation of extraordinary items, and audit requirements. The original use in accounting was in relation to misrepresentation and disclosure. If we can concentrate on these aspects of materiality, I believe the findings will apply equally well to the remaining aspects. This is the approach that has been adopted throughout this paper.

Some History of Materiality

In an artictle I recently wrote for the February, 1972 *Journal of Accountancy*, entitled "Materiality Through the Looking Glass," I traced the history of the use of the term materiality in American accounting and quoted examples to show that the concept was already well established in the early 1900's. I pointed out that the English Chartered Accountants who arrived in the 1880's and 1890's had brought the concept with them, and I showed that the concept was inherent in the provisions of the early British Companies Acts. I quoted the definition of Lord Davey's committee relative to an 1895 updating of these acts that—

> Every contract or fact is material which would influence the judgment of a prudent investor in determining whether he would subscribe for the shares or debentures offered by the prospectus.[1]

The article pointed out that this type of definition was merely the old common law doctrine governing cases of misrepresentation and deceit applied to the sale of securities, and Oliver Wendell Holmes was quoted to show that the American Common Law paralleled the English Common Law in this respect.

The article also reviewed the accounting literature in America on the subject of materiality, pointing out that the earliest articles on the subject date from the 1930's. I surmised that prior to the 1930's accountants generally regarded the term in its legal context; as something for the courts to interpret and not something over which accountants could claim jurisdiction.

The term materiality was increasingly used in "official" accounting literature beginning with the 1930's. An "official" definition from the Securities Acts was incorporated in the S-X Regulations published in 1940, and the term was also used extensively in the early Bulletins of the American Institute. Despite this, writers in the 1930's and 1940's still seem to have regarded the concept as a child of law and only a foster child of accounting and asked for, at most, "a part in any final determination of its meaning."

The Search for Standards

Since the early 1950's a different mood predominates—a search for standards, and a growing conviction that the accounting profession should be the one to establish such standards. This "positivist" attitude has been best represented in the writings of Sam Woolsey and Leopold Bernstein, who believed "standards," "official guidelines," and "border zones" should be established, and established by accountants. In my earlier article I discussed this matter briefly in the light of recent court decisions and articles by non-accountants and suggested that it would be extremely difficult to establish meaningful standards which would embrace "all the circumstances"—to quote the judge in the *BarChris* case. Robert H. Montgomery recognized the problem succinctly in his 1940 sixth edition, which took account of the impact of the Securities Acts, when he said—

> The auditor who examines a balance sheet to be included in a registration statement must decide for himself what the mental processes of the "average prudent investor" might be![2] (The final punctuation is expressive.)

As I see it, the chief difficulty in establishing standards for materiality lies with the common law doctrines of "influence" or "reliance." To quote Oliver Wendell Holmes again—

> It is said that a fraudulent representation must be material to have that effect. But how are we to decide whether it is material or not? It must be by an appeal to ordinary experience to decide whether a belief that the fact was as represented *would naturally have led to, or a contrary belief would naturally have prevented, the making of the contract.*[3] (Emphasis added)

The more modern *Restatement of Torts* says much the same thing.

> A fact is material if its existence or non-existence is a matter to which a reasonable man would attach importance *in determining his course of action in the transaction.* (Emphasis added)

So we see that in the common law it is not so much the nature or extent of the "fact" as the influence it had on the mind of a reasonable man in the particular transaction, and, to quote the judge in *BarChris, ". . . in the light of all the circumstances."*

Professor Louis Loss comments that many of the Blue Sky Laws carry forward the common law concept. With respect to the New York law, he says—

> The offense is committed by material misrepresentation *intended to influence* the bargain, although they may be due to negligence rather than dishonesty.[4] (Emphasis added)

The Securities Acts, where they apply, introduced a different doctrine in that reliance on the misrepresentation is not always necessary—for instance under Section 12(2). This may explain the different emphasis of the SEC definition which—

> . . . limits the information required to those matters as to which an average prudent investor ought reasonably to be informed *before purchasing the securities.*[5] (Emphasis added)

I do not know whether the words "before purchasing the securities" carry with them the thought of influence and reliability. However, if it is argued that materiality has a different meaning under the Securities Acts than under common law or under respective Blue Sky laws, the problem of setting standards becomes doubly difficult. Presumably then materiality would mean one thing for a large private placement of bonds and another for a public sale of common stock under the SEC.

To quote Louis Loss again—

> Inevitably, to be sure, some element of reliance is inherent in the concept of materiality.[6]

So we see that the concepts of "reliance" and "influence" coupled with the requirement to look at "all the circumstances" lie at the heart of difficulties in any attempt to establish accounting standards for materiality. The weight of the accounting data as against the weight of other factors will vary case by case and an accounting misrepresentation that would be material in one situation may well not be material in another. The factors are entirely relative rather than absolute. One wonders whether this dichotomy between relative and absolute values could be at the heart of the disagreement between the Company and its auditors on the one hand and the SEC on the other hand in the Occidental Petroleum matter where, based on the figures given in the Wall Street Journal report, the distortion of net income amounted to $8.9 million out of a total of $174.8 million. We noted above the different emphasis of the SEC definition of materiality.

My own opinion is that if we accept the term materiality with all its attendant legal nuances—and I see no alternative to doing so—it becomes impractical to establish purely accounting standards for the term. I would suggest, however, a practical alternative.

A Practical Alternative: Significant Distortion

The auditor's "certificate" states that the financial statements are fairly presented in accordance with generally accepted accounting principles. We have no professional definition for the word "fairness," but it would seem to me to be more of an intrinsic attribute of the financial statements themselves and less dependent on the many factors involved in the term materiality. If we accept this for the moment, we might establish standards to measure the point at which financial statements *per se* might cease to be "fair"—a standard of "significant distortion" if I may coin a phrase. For instance, we might decide that any distortion in the balance sheet in excess of say five per cent of total assets would be "significant distortion" of the balance sheet, irrespective of the effect in a particular instance on the average prudent investor. The income statement, of course, poses more problems since the standard would have to embrace companies with regular income, companies with cyclical income, and companies with a pattern of negligible income. It might be better to relate such a standard to a theoretical income necessary to provide "normal" return on investment. To cancel the effect of variations in debt/equity ratio as between companies it might be advisable to measure the return on a base of total assets less current liabilities. However, my purpose here is not to offer solutions as to how the standard would

be defined but merely to set the stage. If we adopted such standards we could then require disclosure action or qualification of the auditor's opinion for distortion in excess of such standard—even if *materiality* indicated a higher level. For instance, turning again to *BarChris*, the 15.7 per cent difference in net income might be "significant distortion" even although the judge ruled it was not material.

When materiality considerations suggested a factor lower than the "significant distortion" factor, the lower measure would take effect—a rule of "lower of materiality or standard significant distortion factor." For example, suppose we establish a 10 per cent factor for the income statement, and in a particular case the company is on the verge of breaking through a "times interest" coverage factor affecting its bondholders where a 5 per cent change in income would spell the difference between interest covered and interest not covered. In this case the 10 per cent standard distortion factor might have to give way to the 5 per cent materiality factor.

It is fairly obvious that in those cases where the accounting misrepresentation is the only factor involved which would influence the investor—i.e., ignoring completely such things as nature of industry, size of company, history of stock prices, changes in management, announcement of technology breakthrough, acquisition of significant patents, discovery of new resources, environmental problems, the state of the national economy, and the international financial scene, etc. etc.—then, ignoring all of these except the accounting data,

$$\text{Materiality} = \text{Significant Distortion}$$

This is the problem in evaluating the possibility of establishing *materiality* standards from research studies based on case examples, such as those used by Professor Woolsey in 1954. The responses were answers primarily to levels of significant distortion rather than to real life problems in materiality.

It is for this reason, also, that I do not like the latest (1968) English Institute pronouncement that, "In an accounting sense a matter is material if its nondisclosure, misstatement or omission would be likely to distort the view given by the accounts or other statement under consideration."[7] I don't believe the term materiality can be limited to "in an accounting sense." It may be said that *any* decision by an accountant as to materiality in a particular case is always correct *short of a court of law.* If the decision isn't challenged, then at least pragmatically, the decision was a good one. The court will not limit its judgment to matters "in an accounting sense." I believe the English Institute was seeking to isolate the accounting misrepresentation in the manner I have suggested above and might have solved the problem by recognizing this as "significant distortion" rather than materiality. The English common law and the various Companies Acts have always followed the "reliance" concept with its attendant "in the light of all the circumstances," and I do not believe the Institute's latest definition is meaningful since it obviously seeks to establish a concept of materiality based purely on the accounting data.

Distinguishing Materiality and Significant Distortion

It may be suggested that the above arguments amount to no more than splitting hairs on a matter of semantics. This may be so, but they are hairs of

some importance and this distinction between materiality and significance is somewhat overdue. In 1959 Carman Blough was saying—

> Possibly these (reasonably informative disclosures; materiality; and significance) are terms which defy definition . . .[8]

and the need for the distinction is noticeable in paragraph .11 of the General section of the Current Text of *APB Accounting Principles*, which states—

> The committee contemplates that its opinions will have application only to items *material* and *significant* in the relative circumstances.[9] (Emphasis added)

As things stand today I am not sure what distinction between the terms the committee had in mind.

An interesting situation related to this matter of semantics is evident in looking at the evolution of the present AICPA ethics rule governing misrepresentation. The earliest rule in 1917 used the word "essential," and in 1923 this was changed to "essential and material" with respect to misrepresentation for which disciplinary action could be taken. However, in both cases the rule was left in the broad concept of looking beyond the financial statements in measuring materiality. The 1941 version of Rule 5, which has been readopted as Article 2.02 of the 1965 amendment, reads as follows:

> In expressing an opinion on representations in financial statements which he has examined, a member or an associate shall be held guilty of an act discreditable to the profession if—
> (a) He fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary *to make the financial statements not misleading* (emphasis added)
> (b) He fails to report any material misstatement known to him to appear in the financial statements
> (c) Etc., etc.

It should be noted that paragraph (a) is aimed at the financial statements themselves; paragraph (b) leaves the concept open for the concept of influencing the investor. Paragraph (a) is "significant distortion;" paragraph (b) is "materiality."

Proprietary Considerations

I believe we must take note of the legal origin of the term materiality. I have pointed out before that frequent use of the term in accounting literature does not establish for accountants a proprietary right to the term. The courts would still try us subject to the legal concept of materiality if we had never mentioned the word in accounting literature. Nor do I believe the courts would be overly impressed with any standards we might adopt which looked only to accounting data.

On the other hand the word *significant* is ours to do with what we will—despite some use of the term in SEC literature. We can have significance "in an accounting sense" and can set standards of significance if that seems desirable. However, as I have pointed out above, the adoption of such standards does not

absolve us from making a judgment also in each instance as to whether "in the light of all the circumstances" materiality might not suggest a lower factor.

The question remains, if we adopt standards of significance, how do we police our standards? For instance, how would we deal with those cases where the courts rule that the "significant distortion factor" in a particular instance was not material? This is not an easy matter to decide. However, the present ethics rule with respect to mispresentation of material facts must be even more difficult to apply until some court has made a decision. How, for instance, would the Ethics Committee rule on the facts presented in Occidental Petroleum short of a decision in the courts? It would obviously ease the problem somewhat if their decision in a particular case was based only on the accounting data without the need to examine "all the circumstances." It would seem to me, moreover, that a judge would find a "standard of significant distortion" set by the accounting profession a useful starting point in arriving at his decision in a matter involving materiality. Here would be one factor quantified for him which he could weigh against other factors in arriving at his decision.

Conclusions

Adopting a standard of significant distortion does not do away with the problem of materiality, particularly where other factors indicate a lower level of concern. I have stated that I do not believe we can "standardize" the measure of such other factors. How, then, will the accountant deal with this problem? The first thing is for the accountant to recognize the problem exists. I will repeat a quote from an article written by Martin J. Whitman and Martin Shubik in *The Financial Executive*, May 1971, which takes issue with the importance attached to net income by accountants as a factor in determining or influencing stock market values:

> The accountants, the regulatory authorities, and the so-called fundamentalists have taken a limited tool of analysis which is useful for appraising large, stable public utilities which enjoy little, or no, tax shelter; which reinvest virtually all their retained earnings in their own industry; and whose common stockholders tend to be non-speculative and dividend-income conscious; and they have assumed that this is either the appropriate tool of analysis for almost all investor owned companies or that everyone else thinks that it is an appropriate tool of analysis.

Many of us can remember the late 1950's when certain textile companies with reasonable earnings were selling below book value so that management found it advantageous to buy publicly traded stock into the Treasury to improve earnings per share. The relationship between earnings and market value was less than sensitive. The same can be said for many "start-up" ventures, the cable-T.V. companies being an excellent example in the first four or five years of their existence, when they are building their base load connections. At the other end of the scale are the established "high-flyers" where the market has discounted the future on the basis of an annualized coumpounded rate of growth. The stocks of such companies are significantly more sensitive to any failure to meet the expected earnings. I believe the accountant must make some evaluation of these investor behavioral patterns in assessing a materiality—as distinct from "significant distortion"—decision.

The example I cited earlier with respect to "times interest coverage" with respect to utility bonds suggests another area of sensitivity where contractual clauses of debt agreements impose restrictions of one kind or another on additional borrowing powers, freedom to pay dividends, etc. In marginal situations such restrictions may well influence a materiality decision. The accountant can surely be cognizant of these factors as they arise. I have attached as an Appendix a few additional examples to bring out the scope of the problem.

The examples above, however, do not cover the whole field. Consider the effect of discovery of new oil or gas resources (Alaska), the impact of sudden new technology that makes existing plants obsolete (coke-oven gas when natural gas lines expanded), action of foreign governments (the copper companies), and so on. The items mentioned had such impact on investors that they superseded the reported earnings as a factor influencing investor behavior, sometimes over a period of years.

My rule of "lower of the standard distortion factor or materiality factor" simplifies the problem by at least 50 per cent. The accountant need only concern himself with the situation where the materiality factor is lower—not higher—than the distortion factor. That is, the accounting data must be *more important than usual* and, as influencing the investor, these situations are usually within the ken of the accountant.

And what of the other 50 per cent? I believe we have a way to go before we can come close to standardizing that. Much of stock market response is still pure Barnum & Bailey, a circus where W. C. Fields rates equal time with Graham & Dodd. I will close with the same paragraph I used to close my earlier article.

By all means let us continue to discuss, dispute, dissect, deplore, and generally "look before and after and pine for what is not" in this matter of materiality. My personal opinion is that we must widen our understanding and narrow our judgments—short of official standards.

Footnotes

1. *The Lord Davey Report,* 1895, Cmd. 7779 (1895) par. 14(5).
2. Robert H. Montgomery, *Auditing Theory and Practice,* Sixth Edition, The Ronald Press Company, 1940, p. 58.
3. *The Common Law,* 1963, Belknap Press, Chapter on Voidable Contracts.
4. Louis Loss, *Securities Regulation,* 1951, p. 25.
5. Securities and Exchange Commission, *Regulations S-X,* Rule 1-02.
6. Louis Loss, *op. cit.,* p. 999.
7. Council of the Institute of Chartered Accountants in England and Wales, "Interpretation of 'Material' in Relation to Accounts," 1968.
8. Carman Blough, "Challenge to the Accounting Profession in the United States," *The Journal of Accountancy,* December, 1959.
9. *APB Accounting Principles,* Current Text, 1971, p. 34.

Appendix

Some Interesting Examples Showing Problems in Determining Materiality Purely in Terms of Financial Statements

Cases relatively insensitive to present earnings:

From *Newsweek*—March 6, 1972:

(a) Curtis Wright has doubled in price since January 1 and in one week alone nearly 30% of its shares were traded—all because the company hold limited North American rights to the Wankel engine, and on the fragile theory that the major automakers may turn to the Wankel and suddenly transform Curtis-Wright, one of the market's perennial laggards, into a hot property.

(b) Cartridge Television, Inc.
At current prices the stock market was saying the company was worth close to $75 million. Yet Cartridge T.V. not only hasn't made any profits, it isn't even scheduled to make its first sale until this month. But the company's story is that it hopes to cash in on a long-time dream—a massive consumer market for video recorders and video cassette players.

Cases particularly sensitive to earnings:

From *Newsweek*—July 26, 1971:

When IBM reported that its second-quarter net was unchanged from a year ago at $2.22 a share—and added that the outlook for the rest of the year wasn't exciting—investors stampeded for the exit. The stock slumped 13 points in a single day, continued to drift lower and finally closed the week at $294-1/2 vs. the 1971 high of almost $366.

Discussant's Response to Toward Standards for Materiality(?)

Sam M. Woolsey
University of Houston

Mr. Holmes has prepared a very interesting and thought provoking paper on this elusive problem of materiality. As discussant it is my intention to reinforce and stress the importance of many of his points as they affect the accounting profession. A few of my own concepts on how to handle the problem will be given, either as a modification or an addition to his other comments and conclusions.

Various Meanings of Materiality

Mr. Holmes' references to legal opinions and interpretations given by regulatory bodies have brought out different shades of meaning associated with the word "material." Materiality, as it is used in the narrow sense, relates to the correct recording and reporting of accounting data. Mr. Holmes points out that for a statement to be considered "fair" it must be free of "significant distortion." This concept says that if a statement contains significant *accounting* errors, it should be corrected regardless of the surrounding circumstances and without the necessity of being concerned whether or not the error is large enough to influence the action of the "average prudent investor."

Materiality, in its broadest sense, is related to whether or not the item in question (e.g., the existence of an error) will likely influence the thoughts and actions of the reader when considered under the surrounding circumstances. There may or may not be significant distortion.

I believe that the profession should recognize the difference between the two meanings of materiality (significant distortion and materiality) and that, as Mr. Holmes suggests, the terms "significant distortion factor" and "materiality factor" could be used to identify them. His suggested rule of "lower of standard distortion factor or materiality factor" may become generally accepted by the profession.

Setting Standards

In response to the problem of whether the profession *can* set standards for judging significant distortion and/or materiality, Mr. Holmes implies that it might be possible to establish standards for the former. But he says, "It may be said that *any* decision by an accountant as to materiality in a particular case is always correct *short of a court of law.*" It is hard to believe that a materiality decision is correct just because it has not been challenged and settled in court. If so, how do we explain the situation where one qualified accountant, after

giving consideration to all surrounding circumstances says an item is material while an equally qualified accountant in the same situation says it is not material. Both decisions cannot be correct. Probably what he means is that until a court has decided a case involving materiality no one knows for sure what the *legal* answer is. That situation—difference of opinions (based primarily upon *judgment*) of company accountants, independent auditors, SEC, courts, security analysts, and others—stresses the need for more *objective* guidelines for making materiality decisions as well as decisions related to significant errors.

If this need *is* urgent, should the accounting profession undertake to establish acceptable standards to guide the accountant in his distortion/materiality decisions? Can such standards be set? I wish to give an affirmative response to each question and would like to express my belief as to the *type* and *form* of such standards and to recommend a *general* approach on how to set them.

The errors referred to when attempting to determine if their existence significantly distorts financial statements include errors in recording amounts (or failure to record), errors in statement presentation (e.g., wrong classification of an item or failure to set it out separately), and failure to disclose pertinent information (such as the existence of a contingent liability). It is to be recognized that some errors, because of their nature are not subject to being judged by a significant distortion factor. The answer to the question of how large an error may be before it results in significant distortion may be based on a *relative* amount, expressed percentagewise with upper and lower limits. Suppose that, for a particular type of error, the most relevant base for judging significant distortion is average net income. The *primary* standard distortion factor could be expressed, for example, as 7%—10% of average net income. An error above 10% should be considered as significant, and one below 7% as not significant, unless the accountant can justify departure from this guideline. The gray area (7% to 10%) recognizes that no attempt should be made to set an *exact* dividing line between significant and insignificant errors. A precedent for setting this type of guideline is found in the Committee on Accounting Procedure pronouncement that in the case of stock dividends, retained earnings should be charged for par (or other legal capital base) for *large* dividends and charged with market price of the stock for *small* dividends. The Committee gave a dividend rate range of 20% to 25% as a basis for distinguishing between large and small stock dividends.

For a given instance of an error it is usually necessary to recognize that the significance of an item may have to be judged on two or more bases. A guideline for each base should be established (e.g., 12%—15% of stockholders' equity, 9%—12% of current assets, etc.). An error (or accumulation of errors) would be considered insignificant only if it was found to be insignificant by *each* of the tests applied.

I suggest that some board, such as the newly approved Financial Accounting Standards Board, should be responsible for determining which situations involving errors should have significant distortion factors set for them and it should establish upper and lower limits of the factor in each case. The board need not undertake to study the *entire* problem of significant distortion as one project with the hopes of coming up with a pronouncement covering the entire

field. Instead, a study resulting in a pronouncement could be made of each type of significant distortion, each taken one at a time.

The board, using questionnaires and personal interviews, could identify the most frequently found instances on which accountants have found it necessary to make a significant distortion decision, could determine bases and percentages that have been used in actual practice, and could, after presenting an exposure draft based on the study, come up with guidelines for making a decision related to the type of error in question. Instances of a professional organization or a governmental agency providing numerical guidelines for decision making are not unique. Many examples of this practice are found in APB Opinions and SEC Regulations.

Materiality Standards

But what about errors that are insignificant, but which might be considered as material such that under the existing circumstances they would influence the action or opinion of the reasonably prudent investor, etc.? If the importance of an error is to be determined by Mr. Holmes' rule of "lower of significant distortion factor or materiality factor," there should be some way of determining the latter measure. Mr. Holmes correctly says "we have a way to go before we come close to standardizing that." It is certainly recognized that considerable judgment by the accountant is necessary to decide whether an error or other item would likely influence or mislead an informed reader.

Factors to be considered in making a materiality decision may be of a quantitative nature or of a non-quantitative nature or both. The accountant's judgment may be the *sole* basis for determining materiality if factors to be considered are non-quantitative. However, even in that situation, a standard may provide that the mere existence of an item or circumstance should require its disclosure or special reporting. For most materiality decisions involving *accounting* (quantitative) data, it should be possible to set standards in somewhat the same form as those suggested to provide guidelines for judging significant distortion. Some of these standards could be different in two respects. They could require use of a different base or have a different border zone.

For example, in his recent *Journal of Accountancy* article, Mr. Holmes referred to a recommendation by a well-known analyst that materiality of an error in earnings "be based on the percent of change from the prior year rather than the percent of net income."

In many instances, it may be possible to use the *same* base for a materiality factor—but to set different percentages for the border zone than were set for the significant distortion factor. For example, if the investor likely would be *sensitive* to a change in *trend* of earnings, the standard distortion guideline could be reduced by a certain number of percentage points (hereinafter called points) to provide new limits for judging materiality. Additional circumstances may be found in a particular company such that an error would be considered material for decision and analytical purposes even though it would not result in significantly distorted financial statements. For each type of circumstance a certain number of points could be set as a basis for lowering the guidelines for judging significant distortion to give guidelines to be used to judge materiality. This procedure is somewhat in line with the thinking expressed in Mr. Holmes' paper

when he says, "Suppose we establish a 10 per cent factor for the income statement, and in a particular case the company is on the verge of breaking through a 'times interest' coverage factor affecting its bondholders where a 5 per cent change in income would spell the difference between interest covered and interest not covered. In this case the 10 per cent standard distortion factor might, in some situations, give way to the 5 per cent materiality factor." As Mr. Holmes suggests, circumstances which would cause the materiality factor to be higher should be ignored. Of those circumstances which would cause the materiality factor to be lower, the one which causes the standard distortion factor to be lowered by the greatest number of points should be used to obtain guidelines for judging materiality. As an alternate to using points for adjusting a significant distortion factor to obtain a materiality factor, link relatives may be used. For example, the guideline for judging significant distortion may be 8% to 11% of income in some cases. The existence of an unusual circumstance may require a "70% adjustment factor" which would result in the guideline for judging materiality becoming 5.6% to 7.7% (8% × 70% to 11% × 70%). If appropriate, more than one adjustment factor could be used in this link relative.

A study of all major distortion/materiality problems and the issuing of recommended guidelines for each will take several years. In the meantime, any issued guideline can be revised as it may become appropriate.

Mr. Holmes implies that it is possible to establish standards to measure significant distortion when he says, "My rule of 'lower of standard distortion factor or materiality factor' simplifies the problem at least 50 per cent." That belief certainly seems to be a reasonable one. Although I agree with him that the problem of determining materiality is a much more difficult one, it does seem that guidelines could be provided which would simplify the problem another 20 to 25 per cent.

Benefits

The establishment of guidelines with border zones would provide a tentative answer to a distortion/materiality decision. These benefits should result:

1. The guidelines should be the basis for settling a disagreement on the subject between the company and the independent auditor. The burden of proof is on the one departing from the guideline. The auditor would be much more inclined to "stick to his guns" if his decision agrees with the guidelines.
2. As Mr. Holmes says of court cases, "A judge would find a 'standard of significant distortion' set by the accounting profession a useful starting point in arriving at his decision in a matter involving materiality."
3. An Ethics Committee would have a better basis for making a decision.
4. The use of established guidelines should help close the credulity gap which exists in the minds of many readers who see two qualified accountants making opposite decisions. Statements should be more useful with controversial items handled on a uniform basis.

Mr. Holmes raises the question, "If we adopt standards of significance, how do we police our standards?" That question could be asked about the enforcement of any pronouncement or generally accepted accounting principle. For-

tunately, most accountants are ethical and would try to make a correct decision on a difficult problem if they have some guideline for doing so.

Summary

I wish to commend Mr. Holmes on his very interesting and challenging paper. I agree with most of what he has said. I have tried to show how it would be possible to carry out some of his suggestions, especially those related to the establishment of significant distortion standards. I admit that I feel more optimistic than he and other accountants, as to the practicality of putting the process of making materiality decisions on a more objective basis.

I hope that, as a result of hearing Mr. Holmes' paper and his comments and participating in the discussion which follows, you will want to encourage the development of guidelines to help in the exercise of judgment in making materiality decisions.

Is there merit in trying to set standards? I think so. Will it be an impossible task? Difficult, but not impossible. Will the accounting profession rise to the challenge? I have confidence that it will.

6

Toward a Philosophy of Auditing

R. K. Mautz
Ernst & Ernst (formerly of University of Illinois)

Some may be wondering what more anyone can possibly have to say who has already used two hundred and forty-eight pages of fairly fine print to discuss the philosophy of auditing. This troubles me a little also. The assigned topic may imply that all those pages didn't take us in the right direction. But there are also some advantages in the wording of my assignment. "Toward" is a vague kind of direction, so with such a guide one might be excused if he appears to wander somewhat, and "philosophy" is a word subject to varying interpretation as well.

To refresh myself, I referred to my dictionary and found the following definition of "philosophy":

1) The inquiry into the most comprehensive principles of reality in general, or of some limited sector of it, such as human knowledge or human values
2) The love of wisdom, and the search for it.
3) A philosophical system; also, treatise on such a system.
4) The general laws that furnish the rational explanation of anything: the philosophy of banking.
5) Practical wisdom; fortitude, as in enduring reverses and suffering.

And then two definitions noted as "archaic":

6) Reasoned science; a scientific system: natural philosophy.
7) The sciences as formerly studied in the universities.

This provides quite a range doesn't it? An attempt to establish a fairly specific or limited topic with no more boundaries than those provides so little restriction that almost anything qualifies.

I have tried to reduce it to reasonable dimensions by using my earlier work with Hussein Sharaf as a base, and by trying to tie to what appear to be some current problems. The result combines two quite different kinds of efforts; first an attempt to develop a concept of responsibility that meshes with, or at least is not in conflict with, the concepts of evidence, due audit care, fair presentation, independence, and ethical conduct, which we explored in our *Philosophy*; second, an emphasis, using a "practical wisdom" approach, on something of a personal philosophy for auditors, that is, a way of viewing what our essential responsibilities as auditors are. Thus, the paper centers on two major questions:

1) To whom are we responsible?
2) For what are we responsible?

To Whom Are We Responsible?

The Traditional View. Two conflicting views appear to exist. Traditionally, auditors have considered themselves responsible to the client company as represented by its management. Auditing engagements have come primarily through management. It is the management of the company that makes the arrangements with the auditor to provide audit service.[1] If one goes back far enough, he finds ownership and management identified in the owner-managed company. As companies grew larger and the idea of professional management took hold, a separation between ownership and management appeared, a separation to which many independent auditors may have given less attention than desirable.

Largely ignoring that separation, auditors continued to make audit arrangements with management. At the same time, an increase in the extent of tax and management advisory services plus the emphasis upon constructive auditing, that is, the desire to be of positive help to the client as well as to offer an opinion on financial statements, may have led to an inadvertent identification by independent auditors of the interests of management with the interests of the company. In some cases, perhaps in many, this resulted in efforts to be of as much assistance to the management of client companies as possible.

In many engagements, management is the only interest in the company with which the independent auditor has significant contact. True, the auditor may be invited to the annual meeting of the shareholders, but in appearing there his position is likely to be as an aid to management to answer questions by shareholders and to strengthen the representations of management about the reliability of the financial statements. Certainly in closing conferences on independent audits, unless the company has an audit committee composed of non-officer directors, any discussions of accounting problems are likely to be settled between management and the auditor. Insofar as auditor-client relationships are concerned, in many cases one has difficulty in distinguishing these from auditor-management relationships.

A Competing View. Recently, however, quite a different point of view has been expressed. It may best be summarized, perhaps, in the expression, "The public is the accountant's only client in the world of today."[2] This assertion recognizes a much larger responsibility for independent accountants—and, indeed, a different role for them. It recognizes that there are many users and uses of accounting data, and and that many of those users must be regarded as non-insiders. Public shareholders, creditors who are not represented directly on the board of directors, potential shareholders, financial analysts and fund managers, representatives of labor unions, government planners who rely upon financial statement data as a basis for their prognostications, and members of the general public, all have an interest in financial statements. Yet many of these have no way of assuring themselves that the financial data presented to them are useful or reliable other than to depend upon the services of independent certified public accountants as expressed in audit opinions. This leads some writers to contend that the dependence of these people on CPAs creates a client-type relationship between the auditor and the public.

Those who emphasize this new and expanded role for independent auditors are quick to point out that financial statement data are an important basis for

resource allocation and that the social importance of the nation's resource allocation is such that the work of accountants must be considered to have a strong public interest. They argue that although the audited company pays the bill, the accountant's responsibility runs more to the public and to those outside the company than to the company's management.

Which view is right? There is a great deal of difference philosophically, and I think practically as well, in this emphasis on the public service aspects rather than the client-management aspects of audit responsibility. Let us turn first to an inquiry as to the nature of the client-professional relationship in general. Perhaps we can find some indications here that will help us come to a conclusion.

Nature of the Client-Professional Relationship. With only unusual exceptions, the services of professionals, whether accountants, lawyers, doctors, architects, or others, are obtained on the initiative of the client who selects the professional, has some control over the scope of the engagement, and can terminate the relationship at will. The professional has a direct, contractual relationship with the client and owes the client a degree of loyalty that requires him to resign the engagement if he cannot avoid conflict between the client's interests and the interests of anyone else to whom the professional has a competing responsibility. We find this, for example, in the lawyer's refusal to serve contesting clients and in our own rules about confidentiality.

In the typical situation, the client who has selected the professional compensates him for his work. The relationship is not exactly an employer and employee relationship although there are some similarities. The professional maintains that his expertise not only qualifies him to make independent decisions about the method of accomplishing his objectives, but requires him to establish and maintain a degree of independence from his client in order to be of maximum service. Thus, he is willing to discuss the scope of the engagement in broad general terms but refuses to be limited by a specification of detailed procedures imposed on him by the client.

By no stretch of the imagination does "the public is our only client" notion fit this pattern. Members of the public do not choose the independent auditor, they have no control over the scope of the engagement, they cannot terminate the engagement, nor do they compensate the auditor for his services.

But, then, neither does the notion that management is the auditor's client fit the situation either. In some cases, a company's management may indeed select the auditor, discuss with him the extent of his examination, make arrangements for compensation, and may even be in a position to terminate the examination. But, in so doing, management operates not as an independent user of the auditor's services, but as a representative of the company. It is the company's funds that compensate the auditor, not the management's. Other interests in the company require that the services of the auditor be obtained, and they benefit from those services as much as does management. In more and more cases we see evidence of this relationship as independent auditors are elected, or at least ratified, at shareholder's meetings, and as audit committees made up of non-officer directors work closely with the independent auditors in the development of audit programs and review of the auditor's conclusions.

Ultimately, it is the shareholders who are "the company." Either directly

by them or through their representatives, independent auditors are selected, instructed, compensated, and, if necessary, the audit relationship terminated.

As with the work of other types of professionals, a CPA's services are beneficial to people other than his direct client; they are something of a social good. The nature of his service induces others to rely on financial information, and such reliance leads to financial decisions. If the service is found to be misleading or substandard, a liability on the part of the auditor to others who are not directly his clients may result. CPAs are not the only professionals to face such a possibility. It is not unheard of, for example, for the relatives of a deceased patient to sue the doctor, or for the relatives of victims in a building failure to sue the engineer or architect.

The fact that some type of obligation runs from the professional to people other than the professional's client is not the same thing as establishing a client relationship, however real that obligation may be. If an expression like "the public is our only client" is intended to remind us of this kind of relationship and of the social responsibility of professionals in general, one cannot quarrel with it. However, as a statement of audit responsibility, it is grossly in error and at odds with reality. Further, it may well be a virtual invitation to those who would impute additional responsibility to public accountants.

Some there are in the profession who feel that the independent auditor's burdens are already overwhelming in their potential impact and out of proportion to what he can bear. An open invitation to an unknown number of people with whom he has no direct relationship to consider themselves to be his client with the rights and privileges thus implied borders on the reckless.

The Auditor's Varying Responsibilities. To follow this up a little, note that the CPA has responsibilities to a variety of interests and these vary in extent and nature. He is responsible to:

1) Shareholders. Here the client relationship is at its strongest. He owes to the shareholders his primary loyalty including the duty of maintaining confidential anything that would work an injury to their best interests. [But see (2) and (5).]
2) Management. The CPA has a derivative responsibility to management. The interests of management in the CPA's activities derive from its position as the authorized representative of the shareholders. To the extent that management's requests to the auditor benefit shareholders and do not infringe on the auditor's necessary independence, the auditor should consider them. Improper activities by management, that is, those which injure the interests of the shareholders, are diametrically opposed to those which benefit shareholders.
3) Creditors. Two kinds of creditors can be distinguished: those with a present financial interest and commitment to the company and those with only a potential interest. Surely the auditor's responsibility should not be the same for these. In the one case, there is a real existing financial commitment; in the other there is no more than a possible commitment. Reality and possibility are not the same. A major loan by a bank may be so important to the company and to the bank that all parties at interest agree the bank's relationship is such that it is to have periodic reports of information not provided to others. A contention that such a creditor should be considered to have no rights

to information any greater than the rights of potential minor trade creditors is to ignore both reality and equity.

4) Potential shareholders. Like potential creditors and for the same reasons, potential investors have a claim on the auditors but a more limited one than that of present creditors and investors. To potential investors the auditor owes the responsibility of professional quality work in his examination of financial statements and the opinions he issues thereon. Potential investors have the right to rely on the auditor's opinion and to the extent that it is unreliable because of his substandard work they may have some cause for action against him. They do not have any right to instruct the auditor, to make specific demands upon him, or to influence his selection.

5) General public. If the general public has an interest in the work of auditors separate from that of potential creditors and investors, it must be that they expect the auditor, as a licensed and acknowledged professional, to have appropriate consideration for the public good in all that he does. As a minimum this would mean that the auditor would provide no support of any kind for illegal acts or their concealment.

Conflicting Responsibilities. It is not difficult to conceive of situations when the independent auditor's responsibility to one of these interests might conflict with his responsibility to another. Let us take an extreme case, one in which the management of the company has engaged in an illegal action for the benefit of shareholders. In *The Wreck of the Penn Central*,[3] its authors point out that the Penn Central management was unlawfully involved in attempting to establish an air transportation system in violation of the 1958 Federal Aviation Act which prohibits rail carriers from doing so. Later, the company was fined a total of seventy thousand dollars, allegedly the second largest fine in CAB history.

Now without expressing any views at all on responsibility for discovering such a development, let us assume that independent auditors learned of this activity, knew of its illegality, but, because of their ethical rule requiring that they keep all matters confidential, felt constrained to make no public mention of this. Given the size of the Penn Central, it is quite likely that the potential fine would be considered immaterial. What should the independent auditors do in this situation?

Does the established professional rule requiring confidentiality define appropriate conduct, or can society expect and require something more of auditors? Let me suggest as a tentative conclusion that in a situation of this kind, one in which a company's management is clearly in violation of the law, that management has little, if any, right to claim the loyalty of the auditor. In such cases, may the auditor's loyalty run to another audience? May not society expect the CPA, as part of his professional responsibility, to have concern for all interests, to take into account the specific circumstances, and to give wise professional consideration to the relative rights of all those interests? No single set of rules can cover all possible cases of conflict among those interests. The auditor must have in mind certain general principles regarding the nature of his responsibilities to each of these interests. Given those principles, he must then be prepared to apply "situation ethics" in arriving at a solution to any given conflict.

Summary of Auditor Responsibilities. To whom then is an auditor responsible? To a variety of interests and in a variety of ways. His first responsibility

runs to the present shareholders of the company under examination. In serving them adequately he should supply whatever service to management that is requested and can be provided without violation of his obligation to others. To those others, an auditor has an obligation to perform in accordance with reasonable professional standards and to refuse to condone any actions that are in conflict with established laws or accepted moral standards. This may require that he withdraw from an engagement if he learns of illegal or even immoral acts. In my opinion it would not require that he hold a press conference to disclose it to the world.[4]

My conclusion is that management is not the auditor's client. Neither is the general public. To steer a course that gives proper respect to the relative rights of all the several interests in the auditor's work is not an easy one, but it is the kind of responsibility that can rightfully be expected of professionals.

For What Are We Responsible?

This question is inseparable from the preceding question because in discussing the extent of responsibility which auditors have to the various interests in the company, the nature of that responsibility could not be avoided. Now, however, I would like to explore the question from a different point of view. Let me suggest that the independent auditor is responsible to all interests in his work for:

1) Professional competence.
2) Independence.
3) Authority.

Professional competence has two aspects: technical competence and "social competence." Technical competence includes (1) a knowledge of accounting principles, (2) an understanding of the theory of evidence, which covers the matter of auditing standards, auditing techniques and procedures, and their application in specific situations, (3) an understanding of internal control, and (4) the procedural expertise to perform the steps in an audit program, prepare adequate work papers, develop audit programs, and review the work of subordinates. These are all matters which have been discussed elsewhere and to which I will devote no further attention now.

The Responsibility for Social Competence. Another type of competence at least hinted at in my preceding comments might be described as "social competence." It includes at least three aspects. First, the socially competent auditor must appreciate the role of auditing in the economy. He must accept his task as something more than just getting his client past the Securities and Exchange Commission requirements. He must view his role in the broad sense as an essential step in the allocation of resources and as a factor in the financial decisions of unknown people and organizations. The auditor has an obligation of some sort to all who benefit from allocation of the nation's resources through the functioning of the investment market mechanism, an obligation to avoid any sympathies with the company's management or its shareholders that would permit him to find unrealistic financial presentations to be fair.

He must constantly balance his responsibility to the shareholders against his responsibility to society generally. In the same way, he must recognize that a great many individuals stake their personal fortunes on investments in the com-

pany. He also has a responsibility to balance his obligation to present shareholders against his obligation to potential shareholders and to avoid any unfairness in serving either one of these at the expense of the other.

Social Competence and Competition. Another aspect of social competence is that it is unavoidably affected by one's attitude toward competition. In this country we are strong believers in the benefits of competition. Those benefits run to the services of professional practitioners as well as to business activities. But like so many forces, competition is a good thing only within reason. No, I am not about to take a position on competitive bidding. My interest is of another kind.

Public accounting is a highly competitive profession. On the one hand, this competition undoubtedly urges both individual members and firms in the profession to higher standards of performance, in their desires to retain and attract clients, than might otherwise exist. Unfortunately, an opposite result is also possible. The competitive pressures upon independent CPAs as company managements "shop for accounting principles" could, at least in some cases, result in *lower* rather than higher standards. If we look closely at the nature of competition among public accounting firms we see that it can be effective on three different levels: at the levels of price, of principles, and of service.

Competition on the basis of price is in some ways unfortunate, but it is impossible to avoid. For instance, price competition is within the scope of what the Department of Justice considers desirable, as indicated by recent actions of the Department.

Competition in the matter of accounting principles, if deliberate, should be regarded as almost unforgivable. To the extent that it does occur, it probably is not intentional but rather is an unintended and often unrecognized result of trying to meet the needs of clients in the face of competition from other firms. The ever present knowledge that there are other firms of equal prestige and status that just might see the results of a transaction differently is a specter difficult to shake from the minds of any who make audit decisions.

Competition on the basis of service, to the extent that we can separate service from price and principles, is a good thing and we should be in favor of it. Social competence requires not only that the auditor understand the nature and influence of competition on his decisions but that he discipline himself sufficiently to be constantly alert to its pressures.

Attitude Toward Clients. A final aspect of social competence for the independent auditor is found in his attitude toward his clients. Obviously, he has a responsibility to them to be as efficient, effective, and helpful as he can be. In addition, he fails them in his most important function if he is less independent in the development of his program, in the performance of the work required thereby, and in making audit and accounting judgments than the circumstances require. The auditor also has a responsibility, and a very difficult one, to keep a client's requests and demands in perspective. Certainly there are times when a client's request must be rejected as inappropriate. To the extent that the auditor is aware of and can remember his responsibilities to other interests, he is less likely to accede to requests that have any taint of impropriety.

Is Audit Service an Inalienable Right? Now let me pose two questions which I think are related and rather difficult to answer. First, does an auditor

have a responsibility to avoid unsavory clients? Second, is everyone who needs the services of an independent certified public accountant entitled to obtain those services? I see these two questions to be in conflict. We have, on the one hand, the feeling that auditors will seldom get into any kind of litigation difficulties if they can hold their practice to seasoned and thoroughly reputable companies. On the other hand, companies in the development stage, even those promoted by people with a string of failures, may be considered to have some rights. Certainly they need the services of an independent CPA if a public offering of securities is involved in arranging financing.

One can readily argue that the best interests of the public accounting firm would be to steer clear of any client that might possibly pose financial difficulties. One can also argue that the best interests of the economy require that every promoter be given a chance because we never know when a speculative undertaking may prove to have significant social benefits. Perhaps what we need is something a little like the public defender role played by lawyers. Perhaps some auditors should be designated or assigned to serve clients who otherwise would not be able to obtain the services of a reputable firm. In such cases the "assigned" auditor might require some special protection against litigation.

Another Aspect of Independence. Independent auditors are required to be independent. In this tautology we find one of our most complex concepts. I do not plan to explore it fully here. In their excellent work, Messrs. Carey and Doherty distinguish the self-reliance required of every professional from the special meaning of independence to the CPA.[5] Both Mr. Higgins[6] and Mr. Blough[7] have emphasized the difference between real independence and apparent independence and found both of them significant. Sharaf and I distinguished practitioner independence from profession independence.

To complicate things a little further, let me experiment with two terms which are useful in pointing up another problem related to independence. "Operational independence" was used in our earlier work to describe the kinds of freedom which an auditor must have in developing his audit program, in performing the various verification procedures required by it, and in preparing his report. Without these freedoms he cannot be considered independent. "Attitudinal independence," that is, the state of mind which leads an auditor to be objective in all his decisions, is no more than another name for the traditional "state of mind" description of independence already so well expressed in our professional literature. To be truly independent, an auditor must have both operational independence and attitudinal independence.

Operationally, the freedom to develop a program, to perform it without interference, and to report on the results of that performance is not enough. One must also have sufficient knowledge to utilize that freedom effectively. The less one knows about an industry or about a company the more he must depend upon others for guidance. An auditor unacquainted with a specialized industry or an unfamiliar client may have to ask questions and depend upon the responses he gets to those questions in order to make any progress whatever. Such dependence may infringe on his operational independence as effectively as would deliberate interference by company officers or employees. The less one knows about a company or an industry, the more he must depend upon others. The more he knows the less dependent he is. Some degree of intimate knowledge is

therefore important to independence. One can therefore argue that the performance of management services is directly beneficial to the auditor in that it helps him to attain a degree of understanding and knowledge that he might not be able to obtain in any other way.

Apparently opposed to this is the position we took in our *Philosophy* that auditor participation in the performance of management services may infringe upon the auditor's attitudinal independence. Attitudinal independence requires that the auditor avoid identification of his goals with those of the company and its officers. Any activities that bring him into a more intimate relationship with the company or its personnel may lead him to identify with them, to sympathize with their problems, to view the welfare of the company and the attainment of its objectives as taking precedence over his responsibilities to others. Such identification unavoidably infringes upon attitudinal independence.

Which side do you wish to take? I find myself torn between the two. My good friend, Walter Frese, argues with me that the performance of management services is desirable because it helps the auditor to understand the position of management and therefore to avoid that degree of dependence which ignorance strengthens. My personal inclination is to argue strongly in favor of maintaining attitudinal independence for the auditor and requiring that the extent of audit work be strengthened or expanded sufficiently that true operational independence is possible.

Audit Authority. Those of you who have lasted this far may have noted that I seem to be getting myself into deeper and deeper trouble as I proceed. This last item continues that unfortunate trend. In responding to the question, "For what are we responsible?" I introduced the idea of authority. The independent auditor is responsible for the exercise of authority. I must confess to some reservations about this choice of words, but at the moment have no better one to offer.

Authority has been defined as "the power to command and enforce obedience." Given this definition, what authority does the individual CPA have in the performance of an audit? Our conclusion must be that his authority is tenuous at best. This follows from the nature of the client relationship as well as from our insistence that the financial statements are the client's. As pointed out earlier, the CPA-client relationship is a voluntary one and can be suspended by either the client or the CPA. Hence, if the client feels that he is subject to too much control or authority by his independent auditor, he can terminate the relationship. The initiative is with him to continue or to terminate. Likewise, the fact that compensation flows from the client to the CPA almost unavoidably has some impact. In addition, we have established the position that the financial statements are representations of the client and, as such, that he should have the final decision as to what they will or will not say. This combination of circumstances does not necessarily rob the independent auditor of all "power to command and enforce obedience," but it serves to reduce that authority in a good many individual cases.

Now let us turn to the authority of the CPA profession. Here we find a considerable degree of authority. To the extent that the Securities and Exchange Commission requires that the opinion of an independent CPA accompany the financial statements of a company filing with the Commission, and the listing

requirements of the stock exchanges call for the opinion of an independent CPA, companies are subject to the audit requirements of the profession. I recall a former member of the Securities and Exchange Commission stating that the accounting profession was so vital to business that business could not get along without it. Can you imagine what would happen to a major company if an accounting treatment which its management insisted upon was considered unsatisfactory by *all* CPAs? There seems little doubt but that the company would have to give.

To repeat, then, for the sake of emphasis, the CPA profession has considerable authority. The individual CPA seems to have very little. Therein lies a difficulty.

Perhaps we should give some attention to the question of whether it is desirable that the independent CPA have greater authority. Would we be better off if a company, having once committed itself to a given CPA, had no choice but to accept the CPA's decisions with respect to the presentation of financial statements?

My response to that question is that we would not be better off. I believe strongly that the financial statements must be the company's and that the company should have the freedom to present those financial statements in any way that it pleases. The auditor who finds himself in disagreement with the company's presentation should be expected to so state in his opinion. Is it not conceivable that the company and its auditors could have an honest difference of opinion, one that even after careful examination of all the facts and a thorough understanding of the principles involved might be irreconcilable? In such a situation, are those who use the financial statements better served by a forced agreement, one in which either the views of one or the other dominate or a compromise position is worked out, or would the users be better served by having both presentations made available to them with an explanation of the difference?

What I am getting around to saying is that the time honored policy by the SEC of requiring that qualifications and exceptions be removed from audit opinions may be working to the disadvantage rather than to the advantage of financial statement readers. If the requirement of a clean opinion does force compromise in some cases, if it reduces the total amount of information that otherwise would be available to the readers of financial statements, if it submerges actual and perhaps even justified differences between auditors and company management, is it a good policy?

The purpose of the SEC's policy, of course, is to strengthen the independence of the accountant, and certainly this is important. Can other ways be found to strengthen that independence without submerging useful information?

One source of authority is fear. If I am afraid of a physical beating, I may choose to obey the commands given to me. A company's management may fear an open comparison of its views with those of its auditors. Fear of the withdrawal of its auditor from the engagement may also be effective, particularly if this requires an explanation of the differences between auditor and management at a shareholder's meeting.

At the present time, the auditor's alternatives are limited. If he has a real difference with management, he must take an exception which may well cost him the client and which he has no real opportunity to explain or defend. Alternatively, he can withdraw from the engagement, but here he faces the

same problem in that no one will ever know his reasons. If we could establish his right to report independently of the management, and perhaps even establish a requirement that differences between them must be publicly disclosed, would not his alternatives, his independence, and perhaps even his authority be improved?

Conclusion

By way of conclusion let me confess that for few of the questions raised here today do I even pretend to myself to have final answers. It would be very useful if some authoritative study group would undertake to establish for us the nature and extent of the independent CPA's responsibility to each one of the several interests in financial statements. The tendency to state that "the public is our only client" is a most unfortunate kind of expression, if for no other reason than it implies that we are thoroughly confused about who our client is and what our responsibilities are. It would also be helpful if we could have some extended discussion of whether what I have called social competence is really relevant to the independent CPA's activities.

Perhaps you have had from me very little in the way of "practical wisdom" and a good deal in the way of speculation. I leave it to you to judge. Until we can answer to whom and for what we are responsible, however, we have not advanced very far "toward a philosophy of auditing."

Footnotes

1. In this connection see *Business Week*, March 25, 1972, p. 36 for a note describing SEC consideration of "a staff recommendation that outside directors nominate corporate auditors."
2. See Robert M. Trueblood, *et al.*, "Information for Proprietors and Others," Touche Ross & Co., 1972, p. 29.
3. Joseph R. Daughen & Peter Binzen, *The Wreck of the Penn Central*, Little Brown and Company, Boston, 1971.
4. See Statement on Auditing Procedure No. 41 for the profession's solution to a somewhat similar problem.
5. John L. Carey and William O. Doherty, *Ethical Standards of the Profession*, AICPA, Inc., New York, 1966, p. 18.
6. Thomas G. Higgins, "Professional Ethics: A Time for Reappraisal," *The Journal of Accountancy*, March, 1962, p. 81.
7. Carman G. Blough, "Responsibility to Third Parties," *The Journal of Accountancy*, May, 1960, p. 60.

Discussant's Response to Toward a Philosophy of Auditing

Henry P. Hill
Price Waterhouse & Co.

One of the distinguishing differences between academicians and practitioners is illustrated in this paper. The academic oriented tends to speak in abstractions, searching for generalizations of theory in abstract terms whereas the practitioner tends to use concrete terms and concrete illustrations.

Our chairman was aware of this, I'm sure, when he selected the preparer and discussant of a paper on the topic *Toward a Philosophy of Auditing.* The topic lends itself to a discussion of abstracts, and Dr. Mautz has followed the route that might be expected and has given us a paper inquiring into the theory behind auditing. He has also done a job that someone with a long practicing background like mine could never have done. I think, however, that what's appropriate to inquire into is whether the presence or absence of a theory makes any difference.

I have heard for some time the critics of the accounting profession say that accountants have no idea what the generally accepted accounting principles are that they so glibly refer to. Now Mautz tells us that we don't have a philosophy in support of those examinations we, again so glibly, say we have made. There's only one more accusation that could be made against the professional auditor, which is, "If you don't have a philosophy for your conduct or a frame of reference for its output, why do you bother?" However, despite the inarticulateness of most of its practicing members, there *are* some members of this profession of ours who believe the independent auditor has a useful role in society—and there are some nonaccountants who believe it, too.

Dr. Mautz addresses himself to two questions:

1. "To whom are we responsible"?
2. "For what are we responsible"?

He then proceeds to demonstrate we don't have the answer to either. Let's take them one at a time.

To Whom Are Auditors Responsible?

First—"To whom are we responsible?" Well, to whom is anyone responsible?

Is a policeman responsible only to his lieutenant because his lieutenant is the primary control over his paycheck?

If an airplane crash occurs, does the crew have its responsibility defined as "Get the passengers off the seats so their blood won't stain the upholstery which belongs to the company that pays our salary"?

Of course not! The days of supremacy of property over people are over. Society imposes a responsibility on its functionaries which develops as a reaction to individual situations. Occasionally, of course, this lack of definition backfires as in the case of my staff assistant who laid his coat down on the subway platform and helped an injured victim lie down on it and was sued for causing him physical injury. But, for the most part, it works.

I must say, I am somewhat disturbed by the cynical implications I draw from the part of the paper that discusses relations with management. In the early part of the paper, a point is made that independent auditors may have inadvertently identified the interests of management with the interests of the company. I used the word "cynical" to describe the implications even though I know from the rest of the paper and from other things Mautz has written that cynicism was never intended. Other writers have not been so charitable, however. Some refuse to believe to this day that one or two of us really do believe there's such a thing as a pooling of interests or that immediate recognition is the right way to record investment credit.

I am reminded of a number of dinner table conversations that took place in my house when my sons were approaching their teens. They centered around just what it was that Daddy did during those daylight and evening hours when he was away from home. One friend's father drove an airliner, another owned a print shop, another ran a company that printed school books. Well, to describe my excuse for living, I finally settled on this: "What I do for a living is spend my time convincing people they ought to do some things they don't want to do." Not very illuminating to a nine-year-old, but give me a better one.

It does emphasize, however, that the mature auditor does not make the mistake Mautz attributes to him. He does not mistake the relative positions of management and company. This is what we mean by independence. It's what one of yesterday's speakers was referring to when he spoke of the need for experience.

What this adds up to is that I, for one, don't see the need for any better definition of audit philosophy. I don't see any pressure for improvement in defining responsibility in the terms Bob Mautz has—i.e., to management, shareholders, or the public—debates over *Ultramares* notwithstanding.

For What Are Auditors Responsible?

Mautz's second question is—"For what are we responsible?"—This is the key question if we add to it "and to what extent?" It is the key question because a major apprehension of the accounting profession stems from the potential assessment of financial responsibility against independent accountants for damages that have no relation to any deficient action of the auditor. For example:

> The stockholder who sues for his losses on a highly speculative stock when he never opened, no less read, the prospectus.
> The banker who prides himself in lending on the basis of his evaluation of the person and then wants restitution from accountants for misstated assets.
> The director who cross-claims against the accountants for misleading financials when he himself never really asked a question about them.
> The purchaser of a company who sues the accountant on the basis of

lack of disclosure in the financial statements of facts that even a neophyte would know enough to ask about.

And you can think of others.

We have to start thinking more in terms of responsibility to people who are truly damaged as a result of legitimate use of the financial reports within the purpose for which they were intended; a responsibility measured in financial exposure commensurate with the legitimate assumption of risk. For, after all, if the legal system demands perfection, there are only three ways for accountants to go:

1. Become gamblers, start auditing people rather than facts, take a chance.
2. Raise the total amount of work and the fees.
3. Look for another line of work that's safer, like sandhogging.

Synthesis

Which brings me to a startling conclusion. Despite the negative tone of these comments, I agree with Mautz. The kind of responsibility that should be assigned to accountants "gives proper respect to the relative rights of all the several interests in the auditor's work." That's the "Whom."

As to the "What," I wish he had looked at this proposition: "The auditor is responsible to see that the reader is not misled if he uses the financial statements intelligently according to the purpose for which they were intended."

As usual, after I wrote those words down, I found that G. O. May had said it far better long before I even found myself in the accounting profession.

> I cannot believe that a law is just or can long be maintained in effect which deliberately contemplates the possibility that a purchaser may recover from a person from whom he has not bought, in respect of a statement which at the time of his purchase he had not read, contained in a document which he did not then know to exist, a sum which is not measured by injury resulting from falsity in such statement.

Using my own, less effective, prose, "The auditor is responsible to see that the reader is not misled if he uses the financial statements intelligently according to the purpose for which they were intended." This statement serves to focus on underlying audit philosophy as a means to an end and to avoid what I'm afraid is an ever-present danger in inquiries that involve confusion of means and ends. If an inquiry devotes itself too earnestly to a goal like that contemplated by Mautz's paper, the effort may make the philosophy the goal rather than the means. Should we let that occur, we may someday allow our standards to be governed by the means, i.e., the philosophy, rather than the end, that is, the attesting of financial statements.

This is a very real danger. I am already convinced that some of the assistants on our staff think the objective of their toil is to prepare audit working papers.

Some Final Comments

So much for philosophy. I should like to put forth a few specific comments which may serve to stimulate discussion.

1. When we explore the nature of the client relationship, we may be helped by the fact that originally the auditor had to be a member of the company. That is, he was not even *allowed* to be independent. What better evidence have we that the starting point was responsibility to shareholders. All else is an extension.
2. The auditor's primary responsibility to his client's management is to assist the management to perform properly its responsibility to report to shareholders. To the extent this results in improvements in accounting procedures, etc., it falls within the audit function. Other services may be performed by accounting firms, but just because they are accounting firms does not make the services auditing. Whether accounting firms should be limited to auditing is another question.
3. The primary relationship with shareholders is not confidentiality. It is anything but. Full disclosure and confidentiality are irreconcilable. Obviously, a selection has to be made when a conflict arises, but there's no doubt if full and fair disclosure needed to keep financials from being misleading is pitted against confidentiality, which has to win.
4. Every time there is a temptation to chastise an auditor for not telling something, ask this question: "What has it to do with the audited financial statements?" You'll be surprised how many questions go away. Maybe it *was* morally reprehensible for the Penn Central to get into Executive Airlines. I don't need to pass that judgment, however, if I know (as Mautz points out) the fine of $70,000 is not material. The real question is whether the discontinuance of the air transportation business portends a future change in financial position and results of operations of the company. That's what the auditor talks about and that's what the auditor's responsibility is all about.
5. Finally, let me answer this question that Mautz raises: "Does everyone have a right to an audit?" Well, my answer is that everyone has a right to medical treatment except the guy who's trying to shoot the doctor. There are a lot of people around whose objectives toward the auditor are not much better. I certainly can't see any philosophy that says they have a right to an audit.

7

Future Directions for Auditing Research

Douglas R. Carmichael
American Institute of Certified Public Accountants

In mid-1969 the AICPA's auditing research program was officially launched.[1] For three years I have attempted to plan and initiate a program to provide the Committee on Auditing Procedure, the Institute membership and others interested in the advancement of auditing theory and practice with evidence and information useful in reaching sound decisions on auditing problems. A numbered series of monographs has been authorized and additional staff have been devoted to the effort. We are also beginning to contract for studies by outside researchers. Since we firmly believe that a researcher should have his own independent commitment to a project, we would prefer to find researchers interested in, and working on, a subject rather than commission an individual with no demonstrated interest in the area. The main purposes of this paper are to identify major research problems, or topics, which will be significant in the future; indicate the factors which should be considered in approaching these topics to specify the problem and select a research method; and reflect upon the relationships which should be achieved among research, theory, and practice. An underlying purpose of the paper is to interest qualified individuals in conducting research for the AICPA's auditing research program.

The Relation of Practice, Theory, and Research in Auditing

Research is the meeting ground of theory and practice for any applied field of knowledge. In its most general form, the research process consists of the identification and measurement of variables that are relevant to a given problem or phenomenon and determination of the nature and strength of the interrelationships among these variables. The research process cannot ignore either theory or practice.

Auditing Theory and Practice. The link between theory and practice, however, exists apart from their intersection in the realm of research. In a treatise on accounting theory, A. C. Littleton offered the following observation on this interrelationship:

> Practice is fact and action; theory consists of explanation and reasons. Theory states the reason why accounting action is what it is, why it is not otherwise, or why it might well be otherwise.[2]

While the need for and desirability of a theory of accounting have been well accepted for a respectable length of time, the subject of auditing, until recently, has remained for many a completely practical field of knowledge. From

the "theory as explanation" viewpoint, there has been a steady development of auditing theory on a piecemeal basis. Examples of this piecemeal development include the recognition of auditing standards and their differentiation from procedures, and explication of the nature and classification of evidential matter.

However, a theory is something more than discrete bits of explanation; theory is comprehensive explanation. A theory of auditing should be an organized and systematized body of knowledge of the field of auditing, which identifies the variables of auditing practice and explains their importance, interrelationships, and implications.

At the close of their treatise on auditing theory, Mautz and Sharaf made the following observation on the interrelationship of theory and practice.

> In the past, auditing has been conceived only as a practical subject with little need for or possibility of any underlying theory. Thus attention has been given to its practical applications to the almost complete exclusion of theoretical considerations. We hope we have indicated the close connection between the theory and practice of auditing, for we are convinced that the only sure solution to practical problems is through the development and use of theory.[3]

Thus Mautz and Sharaf propose a relationship of interdependence for auditing theory and practice. Adequate consideration cannot be given to the practical applications of auditing without regard to the supporting theory. On the other hand, auditing theory developed to the exclusion of practical considerations cannot fulfill its primary justification for existence.

Mautz and Sharaf characterize the field of auditing knowledge as

> . . . a rigorous field of study able to make a substantial contribution to our economic life and one requiring considerable attention not only to the development of a systematic and satisfactory theory but to the application of such a theory to its practical problems.[4]

Since auditing is an applied field, its ultimate contribution must be made at the practice level. Thus, the ultimate test of auditing theory is its application to the practical problems of auditing.

Auditing Research. The juncture of theory and practice becomes most apparent and important in auditing research. In broad outline, research relies upon practice to identify problems or phenomena for study and it relies upon theory to guide the complex task of organizing the facts and actions of practice into a systematic pattern. Without a scheme of organization, the real significance of the collected observations of practice might never surpass the level of description. Without the direction of practice to important problems the significance of theory might not escape the level of trivia. Thus, research brings theory into contact with practice for the purpose of expanding knowledge and, in the process, research both explains practice and heightens the impact of theory. These, then, are the general relationships of practice, theory, and research.

Research in Auditing

The above relationships may be highlighted in more detail by a more intensive examination of research. The research process in its ideal form has been described as follows:

First, the scientist notes some phenomenon of interest (Y); in the case of social science, Y is some aspect of human behavior. Then he notes variation in the phenomenon: sometimes Y is present, sometimes not; or sometimes Y exists at a high intensity while it has lower intensity at other times. The scientist then begins a search for concomitants (X's) of the phenomenon Y; that is, he tries to discover conditions (X's) under which Y is or is not present, or conditions (X's) which vary as Y varies. When the scientist has identified an X condition that varies with Y, he then needs to establish whether X causes Y, Y causes X, or X and Y both result from some other phenomenon.

While the general procedure can be stated in a fairly simple form, the research process by which the procedure is carried out is often complicated, requiring elaborate procedures for measuring phenomena (Y's) and associated conditions (X's) and for taking into account the effects of other conditions (Z's).[5]

Although actual research seldom follows this exact chronological sequence, that is the logical sequence of research procedure.

For the moment let us pass the process by which a particular phenomenon of interest is selected for study, and consider the question of research method—measurement of variables relevant to a phenomenon and determination of their interrelationships. A convenient scheme for classifying research methods distinguishes the methods on the basis of the type of setting within which data may be collected. The following classification scheme is based upon the degree of abstractness of the data collection setting.[6]

- I. **Natural Setting**—Data are obtained from real, existing situations of the type to which the results of the study are intended to apply.
  - A. **Surveys**—Typically a random sample of a defined population to determine the distribution of a particular characteristic—usually attitudes, opinions, motivations, or expectations of people.
  - B. **Field Studies**—Study of a situation which includes the phenomenon of interest to observe and records the phenomenon and its surrounding conditions in detail. This method is well suited for exploratory research to determine major variables. In contrast, the survey is a broader study of selected variables.
  - C. **Field Experiments**—A natural setting with some control exercised over selected major variables.
- II. **Abstract Setting**—Data are obtained from a setting constructed by the researcher.
  - A. **Experimental Simulation**—A created situation which is a relatively faithful representation of the natural setting to study the activities of the participants. Such studies vary greatly in terms of the degree of fidelity to reality.
  - B. **Laboratory Experiments**—A setting which abstracts variables from the real situation, represents them in some symbolic form, and studies the operation in that form.
  - C. **Computer Simulation**—A closed model (mathematical) of the situation studied; all variables are built into the model.

Since each of these methods has some disadvantages in terms of what it cannot do as well as some advantages in terms of what it can do, the methods

are not freely interchangeable. The particular research problem should determine the choice of method in any given instance.

Generally, research methods with a natural setting offer less opportunity for control of variables by the researcher than those with an abstract setting. Consequently, in the natural setting, measurement of variables is less precise and less certainty exists that the research results are attributable to a particular variable. On the other band, with more abstract settings, gains in precision of measurement and control of variables are accompanied by a loss of realism. Since the settings are abstracted and artificial representations of the real-life conditions under which the phenomena actually occur, more doubt surrounds the applicability of the research results to real-life situations.

More important than considerations of realism versus precision, is the extent of prior knowledge about the problem implied by the choice of research setting. To use the more abstract settings, the researcher must either know or assume that he knows a good deal more about the phenomenon of interest than with natural settings. In the abstract setting, the researcher *creates* the situation and must know what conditions need to be controlled. As the research setting becomes more abstract, the research results become more and more a function of the structure imposed by the researcher.

Although the natural settings impose less structure on the situation, this does not mean that no structure at all is imposed. The choice of research setting highlights an important relationship between theory and research. When abstract settings are used, the researcher must incorporate theory in the situation before the data are collected. In contrast, when using natural settings the researcher collects the data and then incorporates theory as he interprets the data.

Examples of Auditing Research

Some examples of existing auditing research should make the categories distinguished in this classification of methods a little more meaningful. This review of extant research, for convenience, begins with the more abstract settings. To my knowledge, no computer simulations involving auditing problems have been attempted; the most abstract setting used has been the laboratory experiment.

Behavioral Impact of Audits. Churchill, with the assistance of several others, demonstrated that the performance of the audit function influences the people whose activities are audited. Using laboratory experiments they have shown that both the anticipation of an audit and the occurrence of an audit cause people to modify their behavior.[7] According to these experiments audits evidently exert a positive influence on conformance with prescribed control procedures normally expected.

To conduct the experiments Churchill abstracted the key variables in an audit and represented them symbolically in the laboratory. The subjects were given a simple problem solving task—locating a polluting water station in a water system represented by colored lights in a wired key-board—and a prescribed method for solving of the problem. Some groups were reviewed to see if they complied with the prescribed solution approach and some groups were told they would be reviewed in advance of their first attempt at solving the problem. By ignoring the prescribed method and innovating the subjects could solve the problem more efficiently. Thus, the key elements of an audit were

present: (1) actions of the participants, (2) prescribed criteria for those actions, and (3) a comparison of the actions and the criteria. Note that in the laboratory experiment no attempt is made to recreate the setting of the real situation under study.

Departure from an APB Opinion. Moving up the continuum to the less abstract experimental simulation, a study by Purdy, Smith and Gray indicates that implicit assumptions commonly made concerning the effect of reports on users may not be valid.[8] Their experimental simulation tested the visibility of the required notice of departure from an APB Opinion. In October, 1964, the Council of the AICPA issued a Special Bulletin stating, in part, that departures from an APB Opinion if they have "substantial authoritative support," may be disclosed either (1) in the auditor's report or (2) in a footnote to the financial statements, with no qualification of the auditor's opinion. This study measured the visibility of these two alternative methods of disclosure to financial statement users. Contrary to normal expectations, the researchers found that the two forms of disclosure—footnote versus auditor's report—were equally visible to financial statement users.

The research method involved several groups of businessmen familiar with financial statements—such as bankers—who were presented with a set of financial statements accompanied by footnotes and an auditor's report. Some groups received statements disclosing the departure in a footnote while others received statements disclosing the departure in the audit report. These subjects were then asked questions about the statements.

In contrast to the laboratory experiment, the experimental simulation attempted to achieve some degree of fidelity to reality. Although the participants realized that they were involved in some sort of research study, there was an attempt to approximate the actual analysis of financial statements.

Confirmation of Receivables. Several field experiments have been conducted of the audit procedure of mail confirmation.[9] In all the studies confirmation requests were sent to actual individuals or businesses. Thus, the setting was natural and the control exercised by researchers involved only major variables—the form of the confirmation request and the dollar amount of the account balance identified in the request (two studies) or a surrogate for the balance.

Auditee Attitudes. Churchill followed his laboratory studies of the audit process with a field study. Field interviews of people in organizations who had experienced audits (auditees) indicated that they do not perceive the audit as influencing their behavior, and view it primarily as a procedural check and somewhat of a policing function.[10] These results are in direct contrast to the laboratory findings that audits did influence behavior.

While the conflicting results of these two studies need not concern us here, their temporal order is of interest. The research began at the abstract setting stage with laboratory experiments. The question I wish to raise is whether auditing researchers should first conduct more extensive studies using a natural setting. In the social sciences, one researcher suggested this ordered progression in the use of research methods.

> If we are starting research on a relatively unexplored phenomenon, it would seem best to start far over at the field study end of the continuum. As we learn more about the problem, we can then work with

methods further along the continuum, with which we can gain more precise information. Then having explored the problem with precision and in depth, and perhaps having formulated and thoroughly manipulated a formal model, we can return toward the field study end of the street to find out how closely our presentations fit the phenomena of the real world.[11]

This suggested order, at least, proved beneficial in a study of criteria used for the different types of auditor's reports.[12]

The AICPA's ARM No. 1. The study of the fourth standard of reporting described in Auditing Research Monograph No. 1 used a natural setting—the field study. The choice of research setting was more or less dictated by the extent of prior knowledge of the reporting decision process. With so little prior knowledge, an explanatory study was needed to identify the important variables. The purpose of the study was to determine the meaning of "sufficiently material," the single reporting criterion offered in Chapter 10 of SAP No. 33 for distinguishing between qualified opinions and adverse opinions and disclaimers of opinion.

It is interesting to consider how the choice of another method might have influenced the research results. If an abstract setting, such as an experimental simulation or a laboratory experiment, had been chosen, certain assumptions would have been necessary in the design of the study. If "sufficiently material" had been equated with relative magnitude, that variable would have been manipulated by varying the dollar impact of the exception. Research results would have established relative magnitude cut-off points for distinguishing between "material" and "sufficiently material" based on reporting decisions made by the subjects. Note the extent to which the research results would have been influenced by the structure imposed on the setting. On the other hand, research results obtained by a case by case study of audit reports indicate that certain qualitative variables seem to be more important than, or at least as important as, the quantitative variable.

Surveys. Recently, there has been a virtual explosion of surveys dealing with auditing topics. In fact they are too numerous to identify specifically, and singling any one study out for attention is not essential since most accountants are by now quite familiar with this type of research. However, far too many of the current surveys deal with insignificant problems and, in my view, the survey method of research is being abused today. This observation naturally leads to the critical question: What are the significant problems which should attract the attention of auditing researchers?

Recommendations for Future Research

Developments in auditing research, theory, and practice are by nature evolutionary. For example, the research reported in ARM No. 1 should serve as a foundation, or at least provide a background, for future study of the decision-making process of auditors in reporting. ARM No. 1 identifies the central reporting concepts and describes the role of these concepts in reporting decisions. With limited prior knowledge about the subject, the research method sacrificed some precision and several questions remain to be answered. Care was taken to obtain the data from real, existing situations of the type to which the results

were intended to apply. This constraint need not be applied so stringently in future studies, and precision of measurement may be increased by using more abstract methods—with one or two important reporting concepts isolated for study. This approach makes possible exploration of phenomena which do not occur frequently in practice, such as situations leading to adverse opinions. However, the reporting decision process is certainly not the only important research topic. Many other subjects are important, some of which are outlined below.

A. Expansion of the attest function
   1. Historical financial summaries: what are the minimum requirements for fair presentation?
   2. Interim financial statements: what evidential matter is necessary to support an opinion, and can the evidence-gathering process be structured to implement the continuous auditing concept?
   3. Forecasts and projected financial statements: what degree of responsibility for assumptions should the CPA assume in light of the nature of evidence available and the comprehension capabilities of the report reader?
   4. Operational auditing: what type of audit report is appropriate and what form of evidential matter is adequate to support the report when propriety criteria are not well formulated?

B. Refinement of auditing methods
   1. Use of other experts: in what circumstances should evidential matter include the work of other experts, such as geologists, actuaries, lawyers, or engineers; should any reference be made to these experts in the audit report?
   2. Auditing fair value: what forms of evidential matter are necessary to support an opinion on financial information based upon fair value rather than historical cost?

C. Professional responsibilities
   1. Objectivity and integrity: what alternative arrangements for selecting, changing, and compensating auditors would be feasible?
   2. Communication responsibility: to whom—both within the audited entity and outside the entity—and in what manner should the auditor communicate knowledge which may fall outside the audit report on financial statements, such as illegal acts, internal control weaknesses, and improper client-prepared financial information?

These are the auditing subjects which I would regard as most significant for future study. Each topic is followed by the major question to be answered, which would have to be reduced to a number of relevant researchable questions. This distinction is very important—in fact, critical. Each problem must be specified in terms of more specific researchable questions so that evidence and information may be gathered that bears directly on the problem. Mautz and Gray expressed the point in this way:

> The specific issue must be stated in such a way that it meets the needs for which the research is proposed and indicates the kind of evidence relevant to the research subject. The research methodology must be such that it will provide convincing evidence and valid reasoning from that evidence.[13]

The Mautz and Gray article is such a well-reasoned blueprint for effective re search that expanding greatly upon what they have said so well is not necessary. In the auditing research program, we have endeavored to follow a similar approach from the very beginning of the formal program.

Development of ARM No. 1

Problem specification is such an important aspect of research that I would like to explore, as an illustration, some of the factors considered in the preparation of ARM No. 1. Many, if not most, discussions of research method focus on the steps in the process after the phenomenon of interest has been selected for study and the problem specified in some detail. However, problem selection and specification are critical steps in the research process. It is at this point that research should draw significantly upon practice. The difficult problems in practice, at the profession level, should identify what phenomena require study and explication. Determination of the important questions to be answered—specification of the problem—should also rely heavily on practice. An exploratory review of practice to determine the major questions to be answered should be undertaken in every study no matter what research setting is chosen to collect data.

In the study of the fourth reporting standard reported in ARM No. 1, an initial study of practice disclosed that the primary problem was lack of criteria for the distinction between a "subject to" qualification and a disclaimer of opinion. Consequently, uncertainty exceptions received the bulk of attention in the study. Further exploration disclosed that one particular type of uncertainty exception—the going-concern problem—was of major importance and, therefore, that subject was given more extensive treatment than other types of uncertainties.

For a number of reasons, research directed to the influence of audit reports in the decision process of financial statement users did not seem appropriate for an initial study. Although future research should definitely consider this dimension of the reporting process, careful attention should be given to those factors that eliminated that approach as an initial choice.

To study the decision process of financial statement users and retain control over the relevant variables, an experimental simulation or a laboratory experiment would seem to be the most logical choice for a data collection setting. The problems involved in this research approach can be conveniently explored by considering one possible experiment. If we want to test the users' reaction to different types of audit reports when a material uncertainty is present, we might prepare a set of financial statements for a company that has a large amount of research and development cost of doubtful recoverability with extensive footnote disclosure of the problem. Different groups would be presented with the financial statements and accompanying auditor's report and control would be exercised over the type of report. One group would receive statements with a qualified opinion, another group would receive the same statements with a disclaimer of opinion, and the statements received by a third group would be accompanied by an unqualified opinion. Other sets of financial statements would be used to vary the relative magnitude of the amount involved. In this manner, the impact of the type of audit report on users could be measured. However, while establishing the data stimuli is not too difficult, the method of measuring response is more troublesome.

An easy approach would be to allow the subjects to read through the information and then, without allowing reference to the statements, have them answer a series of questions about the statements. In this fashion, it would be possible to determine whether variations in the audit report created a greater awareness of the uncertainty problem. However, this approach does not get at the critical question of whether the audit report has an impact on the decision process of the user. Would variations in the audit report cause any change in the user's decision? Would the different decisions be better decisions?

Research on the impact of the audit report on the decision process adds an extremely complex element to an already difficult research problem. Research of this sort would require some knowledge of the financial statement user's forecasting model (conversion of historical data into estimates of the future) and his decision model (interaction of the estimates in reaching a decision). Research on the decision process typically assumes that all data presented to the subjects is of equal reliability. The subject is given no reason to doubt the veracity of the data. Introducing degrees of qualification concerning the reliability of the data considerably complicates the research problem.

Usually in research of this type, to achieve adequate controls over the experimental situation, the phenomenon of interest must be simplified to such an extent that only a portion of the phenomenon can be captured and the research results are of doubtful applicability to the real world situation abstracted in the experiment. Consequently, the potential results of this type of research did not hold enough promise to serve as a basis for major policy decisions. In addition, with so little information available on the decision process of auditors, establishing the criteria actually used by auditors seemed to be a more logical starting point. Future research, however, should begin to delve into this complex aspect of the reporting process.

Those of us involved in the auditing research effort at the AICPA hope that the above list will serve as an early identification of significant research topics and stimulate the interest of academic researchers capable of performing adequate research on the issues.

Research Environment

Those performing research, however, should recognize that a distinction exists between academic and, for want of a better word, institutional research—meaning research conducted for a professional organization. Naturally, we expect the two to be different and some of the differences are legitimate, but others are of doubtful merit and might well be eliminated.

Time-Span. Generally, academic research may be conducted over a longer time-span. Time constraints are usually personal and imposed by the desire or interest of the researcher. An academic researcher may envision a series of related studies conducted over a long period of time with each new study adding additional refinements to the previous effort. Institutional research must usually go directly from research results to implementing guidelines for practice. The study is usually related to the development of a professional pronouncement or a firm position and pressing deadlines may be attached to these publications.

Real-World Referents. Academic research frequently opts for the simplifica-

tion and control of highly abstract research settings. Experiments and simulations allow precise measurement of variables, which is attractive even though there may be some doubt about the applicability of the results to the "real world." On the other hand, institutional research must often accept the loss of rigor and control to gain greater confidence that the research results are applicable to practice.

Audience. Academic research is in many cases unabashedly aimed at other academicians, while institutional research must satisfy policy makers and practitioners as well as other researchers. Since these groups undoubtedly have different norms and values, the reaction to institutional research results is likely to be mixed.

Subject Choice. Institutional research almost always begins with a problem to be solved. The research method must be fit to the problem and there is little opportunity for restricting and tailoring the problem so that it may be answered by the available evidence. If the problem is defined and narrowed too much, the institutional researcher will fall far short of his task. In contrast, academic researchers in many cases seem to choose a research method they would like to employ and then search for a problem that might be solved by that method.

Bureaucratic Infringement. Institutional research seems to be obviously plagued by possible conflicts between bureaucratic and professional norms. However, the academic researcher has a similar problem. In fact, his plight may be greater because the problem is much harder to recognize. The university is a complex oganization and survival and advancement in the academic community at times requires compliance with norms that may be in conflict with the ideals of a scholar. Blind adherence to an in vogue research method may take precedence over generation of fresh insight on difficult problems. The nonparametric test of significance may assume more importance than the actual significance—meaning relevance and importance—of the research results to the resolution of any real problem. As a consequence, too often academic research results in a glorification of technicians over discoverers, quantification for its own sake, and fitting problems to research techniques rather than the reverse.

Concluding Remarks

Auditing theory is important, but theory developed in isolation from the problems of practice at the profession level has little significance and risks being trivial. Note that there is a substantial difference between those problems which face the auditing profession collectively and those problems raised in each individual audit.

To be worthwhile in the effort of solving significant problems, auditing research must be empirical. Nevertheless, deductive reasoning and attention to theory may never be ignored, and these elements should play an instrumental part in any auditing research. A clear specification of the problem, which is primarily a process of logic, may be the most important step in the research process. However, a convincing solution to an important problem is not likely without empirical evidence on the issues.

There are many forms of empirical research. Too often empirical research in accounting has meant research methods employing an abstract data collection setting, with the possible exception of the ubiquitous "survey." At this stage in the development of the auditing field of knowledge, there is probably a greater

need for field studies and field experiments, or at least a combination of these methods with the more abstract methods in an ordered program of research.

In closing, I would not discourage any auditing research, but I would *encourage* research directed to the problems identified in this paper; research that gives full recognition to the role of practice, as well as theory, in the research process. There is no legitimate distinction between theoretical and applied research in auditing since neither theory nor practice can reach its full potential without the other.

Footnotes

1. See "The Auditing Research Program," *The Journal of Accountancy,* October, 1970, pp. 90-91, for a more complete explanation.

2. A. C. Littleton, *Structure of Accounting Theory,* American Accounting Association, 1953, p. 132.

3. R. K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing,* American Accounting Association, 1961, p. 248.

4. *Ibid.,* p. 245.

5. Joseph E. McGrath, *Social Psychology,* Holt, Rinehart and Winston, New York, 1964, p. 23.

6. Adapted from Joseph E. McGrath, "Toward a 'Theory of Method' for Research on Organizations," Cooper, Leavitt, and Shelley (eds.), *New Perspectives in Organization Research,* John Wiley & Sons, New York, 1964, pp. 535-540.

7. Neil C. Churchill, and William W. Cooper, "Effects of Auditing Records: Individual Task Accomplishment and Organization Objectives," *New Perspectives in Organization Research,* eds. W. W. Cooper, H. J. Leavitt, and M. W. Shelley, John Wiley and Sons, Inc., 1964, pp. 250-275; Neil C. Churchill, William W. Cooper, and Trevor Sainsbury, "Laboratory and Field Studies of the Behavioral Effect of Audits," *Management Controls,* Bonini, Jaedicke, and Wagner (eds.), McGraw-Hill, Inc., 1964, pp. 253-267.

8. Charles R. Purdy, Jay M. Smith, and Jack Gray, "The Visibility of the Auditor's Disclosure of Deviance from APB Opinion; An Empirical Test," *Empirical Research in Accounting: Selected Studies 1969.*

9. Thomas D. Hubbard and Jerry B. Bullington, "Positive and Negative Confirmation Requests—A Test," *The Journal of Accountancy,* March, 1972, pp. 48-56; Eugene Sauls, "Nonsampling Errors in Accounts Receivable Confirmation," *The Accounting Review,* January, 1972, pp. 109-115; Gordon Davis, John Neter, and Roger Palmer, "An Experimental Study of Audit Confirmation," *The Journal of Accountancy,* June, 1967, pp. 36-44. For an analysis of the import of this type of research see the article review of an earlier study by Sauls in *The Journal of Accountancy,* November, 1971, p. 94.

10. Neil C. Churchill and William W. Cooper, "A Field Study of Internal Auditing," *The Accounting Review,* October, 1965, pp. 767-781.

11. McGrath, *ibid.,* p. 555.

12. The monograph, "The Auditor's Reporting Obligation," will be published in Fall 1972 as the first in a numbered series.

13. R. K. Mautz and Jack Gray, "Some Thoughts on Research Needs in Accounting," *The Journal of Accountancy,* September, 1970, p. 58.

Discussant's Response to Future Directions for Auditing Research

Frederick L. Neumann
University of Illinois

We are indebted to Mr. Carmichael for stimulating our awareness of auditing as a subject for research, for broadening our perspective as to the challenges it presents, and for reminding us of the varied forms such research may take.

One of the difficulties in discussing research is the plethora of terms, the abundance of jargon, and the attendant confusion which inevitably results from the clash of varying philosophies that abound in this area. In this respect, at least, it's easy to believe that scientists were called philosophers well into the middle of the last century.

One of the first exercises we assign our Masters' students in their research course is to have them define and discuss their concept of research. You would be amazed at the range of views this term conjures up. It is for this reason that, when discussing this area, one must be very careful in defining terms and creating classifications to be sure they are not only understood but are also appropriate to the intended use. We must try to select those properties for partitioning our subject matter which will provide the most useful set of pigeonholes for the purpose at hand. I would like to employ some of the classifications used in Mr. Carmichael's paper as a means of discussing some of the issues they raise.

Theoretical vs. Applied Research

For example, it is inevitable that one or more of our Masters' students will introduce the theoretical vs. applied dichotomy in discussing research. This distinction may have some advantages conceptually, but it can be confusing when applied to actual research. It may be used with some benefit to describe the motivation for specific research, but it can be misleading if employed to label the results.

I can understand Mr. Carmichael's considerable interest in applied auditing research but the role of theoretical research in auditing should not be neglected. (Hopefully, I will be able to avoid any of the semantic traps I have warned against above.)

Kerlinger defines theory as ". . . a set of interrelated constructs, definitions, and propositions that presents a systematic view of phenomena by specifying relations among variables, with the purpose of explaining and predicting phenomena."[1]

The role of theory is to provide general explanations of empirical events and objects to enable us to link together our knowledge of separate occurrences and predict events yet unknown. It helps to identify relevant variables and the

relationships between them—regularities which we can express in generalizations. Without it we have difficulty classifying our knowledge and evaluating our findings. It also helps to direct further research. As has been said, "There is nothing more practical than a good theory."

Primary induction, to attempt to find explanations for observed behavior, is interesting and useful for learning facts and developing hypotheses; but our ultimate goal must be secondary induction, which seeks to incorporate results of primary induction into an explanatory theory covering a wide range of inquiry. Limited, specific research projects have their value. Theoretical research, however, is the more general and more widely applicable. I, therefore, believe it is essential for reasonable progress.

Without adequate theory we may lack direction, proper perspective, and consistency in our decisions. We have already experienced—in the problems of the APB—some of the consequences of pragmatically based decisions. As *Business Week* recently noted about activity in accounting, "When loopholes are closed and detailed rules are drawn up on an issue-by-issue basis, the result often is illogical, arbitrary, and inconsistent."[2]

Without adequate theory, we may extend current actions which are faulty —simply because they are generally practiced—and, thus, compound the error. Whitehead pointed out a similar fallacy with regard to common sense by observing, "Its sole criterion for judgment is that the new ideas shall look like the old ones."[3] Mr. Carmichael seems to favor a role for theory but appears to link it very closely to the problems of practice. Were others to extend this emphasis unduly, it could have unfortunate consequences.

Bernstein states that applied accounting research, ". . . has more limited objectives and addresses itself to finding the most feasible and best possible solutions to specific problem areas."[4] A preoccupation with practice may tend to focus primarily on the present state of knowledge to the neglect of its future development. Lynd has observed that, while ". . . the role of the learned man in earlier times may have been to stabilize custom and to conserve the past; . . . the social scientist, as his modern day counterpart [and I view the accountant in this light] . . . is bound more closely to the moving front edge of man's experience."[5] Lynd continues:

> This means that, granting all due weight to the institutionalized past as it conditions present behavior, the variables in the social scientist's equation must include not only the given set of structured institutions, but also *what the present human carriers of those institutions are groping to become*.[6]

In the same *Business Week* article cited above, James S. Mahon, a partner in Lybrand, Ross Bros. & Montgomery, ascribes the public's current disillusionment with accounting to the failure of the profession to discern three significant trends in attitude:

> First, we failed to perceive the growing cleavage between independent ownership and professional management; second, we were slow to recognize the emerging power of the institutional investor in the financial community; third, and perhaps most important, we did not anticipate the public clamor for exactitude in financial reporting.[7]

A singular focus on practice is apt to result in more of such surprises.

Furthermore, to overemphasize practice could lead to the neglect of a vast amount of knowledge being developed in related fields. As Justin Davidson has observed:

> But perhaps the most serious flaw in the present arrangements is the fact that needed knowledge of vital interest to the accounting profession is simply not produced—whole areas of important subject matter can be, and have been, completely overlooked so far as research is concerned.[8]

Moreover, Mr. Carmichael's hope that a theory of auditing that will be a "comprehensive explanation . . . an organized systematized body of knowledge" may be illusory if it is drawn from practice which is itself inconsistent, unorganized and unsystematic in its approach to problems.

There are indeed numerous, pressing problems in practice today for which there is very little, if any, "evidence and information available to assist in reaching sound decisions." And the situation looks as though it may get worse before it gets better. Nevertheless, if one were to be overly attentive to these practical issues, without an equal awareness and development of the broad-based theory which underlies—or should underly—this area, he would be asking for more of the same confusion which plagues the profession today.

Academic vs. Institutional Research

Another dichotomy in Carmichael's paper which, if improperly interpreted, could lead us astray is the one of academic vs. institutional research. Again, this is a distinction which may play a useful role when properly applied but which can also be the cause of mischief if carried beyond the bounds of its relevant range.

Mautz and Gray, in the article cited by Carmichael, allude to such a distinction as one means of describing past developments and explaining the current status.[9] The Wheat Committee and others have done so, as well. While it may be a useful classification in such a context, it should not be interpreted as a necessary characterization of research endeavors in the years ahead. If Mr. Carmichael's remarks were extended in this latter manner, these terms could have the unfortunate consequence of hardening lines of demarcation which are at once unnecessary and potentially deleterious. Such a misinterpretation could perpetuate distinctions which are not germane to the needs of research. Rather than a possible further widening of the breach, what we need is a greater effort to narrow the differences. Let's not perpetuate the unfortunate stereotype of the academician as one who is only incidentally interested in the problems of the man on the firing line. Alternatively, there is Chambers' characterization of the practitioner as ". . . concerned with analysis of the immediate problem context of a client."[10] Each party has certain skills and knowledge which may be of significant help in solving the problems of auditing. Our abilities should be of more interest than our orientation. In fact, we have some empirical evidence present here at this conference that this is so and I heartily endorse the suggestion that there be "more attempts at cooperative research linking practitioners and theorists in joint efforts."[11]

I would recommend to the Institute—and to public accounting firms as

well—that, rather than sort out projects in terms of academic vs. institutional interest, they endeavor to combine the best attributes of people in both areas and seek to assign practitioners and academicians to the same project. It may require that those oriented toward practice develop a better understanding of research and a greater appreciation of the role of theory. Some theoreticians on the other hand may have to descend from their ivory towers to learn more about the realities of practice.

The Wheat Committee has estimated one year as sufficient time to complete most accounting research studies.[12] Many firms now offer internships to faculty to experience auditing "like it is." Why couldn't there be faculty *research* internships as well?—or, for that matter, practitioner sabbaticals? They could be at a firm's office; or some practitioners might find it easier to do such work on the campus. Also, there is the growing manpower represented by retired practitioners and professors, as well. There would seem to be much potential for cooperation.

Research Methodology

Joint projects might also succeed in getting a better hearing for their results. The failure of accounting research, to date, to attract more attention, is a problem that concerned Mautz and Gray among others.[13] One explanation hypothesized by them for this condition is the lack of an established research methodology.[14] It may be that we have been derelict in its use but the classical approach of scientific methodology is as applicable to auditing as it is to any social science. We may be impatient that such an approach offers, at best, slow and tedious progress; but it is still the most dependable route to reliable knowledge that man has yet found. As Pierce has noted,

> To satisfy our doubts, . . . therefore, it is necessary that a method should be found by which our beliefs may be determined by nothing human, but by some external permanency—by something upon which our thinking has no effect . . . The method must be such that the ultimate conclusion of every man shall be the same. Such is the method of science. Its fundamental hypothesis . . . is this: There are real things, whose characters are entirely independent of our opinions about them . . . .[15]

Carmichael has stressed—and rightly, I believe—the importance of problem specification as the first step. If a researcher wishes to solve a problem he must know what that problem is. Progress toward the solution is significantly enhanced when the researcher determines what it is he is attempting to do. Problems are perhaps best expressed as questions about the relationship of two or more variables—hopefully, with some indication as to the potential solution.

Carmichael emphasizes the need at this point for a close tie to practice. Practice "should identify what phenomena require study and explication." Again, I am reluctant to place such a heavy emphasis on practice. I noted, above, my fears that using practice as the primary referrent may lead to compounding errors. Primary reliance on the perceptions of the practitioner without due consideration of the broader issues and of theory may be short-sighted and could be quite harmful. As the paper observes, "In its most general form, the research process consists of the identification and measurement of variables that

are relevant to a given problem or phenomenon . . ." A singular focus on practice could overlook significant variables and, as a consequence, result in incomplete observation, inadequate data collection, and misleading results. The selection process sets in motion the empirical testing program which Carmichael feels is so important. Limiting the selection process to considerations of practice may very well bias the program and provide results which are deceptive.

The classical approach of science to a problem is through the formulation of an hypothesis—a tentative or conjectural statement about the relationship between the variables in question, propounded with the object of following out its consequences. Morris Cohen has noted,

> There is . . . no genuine progress in scientific insight through the Baconian method of accumulating empirical facts without hypotheses or anticipation of nature. Without some guiding idea we do not know what facts to gather. Without something to prove, we cannot determine what is relevant and what is irrelevant.[16]

Hypotheses may be derived from theory and are a means of extending theory. They should be testable and, under proper conditions, can be demonstrated to be probably true or probably false, independent of man's beliefs or desires. They are a very powerful tool in acquiring dependable knowledge.

Mr. Carmichael might have formulated several hypotheses in response to his problem in ARM No. 1, to determine the variables used in defining "sufficiently material." There is ample precedent in the literature, for example, to have hypothesized certain financial statement measures as both necessary and sufficient conditions for defining this term.

The next step after hypothesis formulation is to deduce testable consequences from the selected hypothesis. There is little to be gained from metaphysical hypotheses that have no testable implications. In ARM No. 1, this step could have led, as Carmichael suggests, to "if . . . then" propositions that certain relative magnitudes on the financial statements would prompt practitioners to change their opinions from "qualified" to either "adverse" or "disclaimed." It should be noted that the process of formulating hypotheses can often aid in clarifying problem statements as well as in leading to operational implications and testing situations.

The test of the hypothesized relation then follows, to see if, under the deduced conditions, that relationship seems to hold. Here the role of the hypothesis may become clearer. For without some guide as to what is to be watched, incomplete and inaccurate observations may be made.

Mr. Carmichael has spelled out in his paper one way in which an hypothesis, such as the one just propounded, might be tested. He thus gives recognition to the amenability of auditing phenomena to scientific research methodology.

It should be noted, as Dewey points out, that this methodology, in implementation, is usually not as neatly defined.[17] The sequence may be irregular. Steps may overlap and mutually support each other in development.

Carmichael chose an alternative approach to his problem, however, for the reasons explained in his paper. He undertook the study with apparently no clearly formulated hypotheses but an awareness of the variables which might possibly be at work in the decision process. In view of the primitive stage of our theory and the pressing need for decisions, perhaps the best route to knowl-

edge about particular issues is to identify as many possible independent variables as we can, to come up with as many possible explanations as Marvin Stone can dream up, and undertake large data gathering projects that are guided, of course, by appropriate statistical methodology. Properly done, such efforts may permit us to narrow more rapidly the bounds of probability and to focus more readily on subsequent investigation.

Topics for Investigation

I might also observe that such studies as these that we have been discussing are of a positive nature—that is, they seek to explain what is and, thereby, to predict what will be. That is consistent with our common preoccupation: witness "generally accepted" accounting principles and "generally accepted" auditing standards. This orientation, however, tends to overlook any normative aspects—what should be. Remember, to Judge Friendly in the Continental Vending Case, as we noted yesterday, generally accepted accounting principles did not necessarily result in "fair presentation."

In one sense, research into normative aspects could result from findings regarding user behavior. Developments in this regard could conceivably be tested as Mr. Carmichael has noted. In another sense, however, normative behavior enmeshes both the user and the auditor in questions of value. Questions of this nature are almost impossible to test with the approach suggested above.

In his proposed topics for research, Carmichael has presented a rather far-ranging set of suggested challenges. Investigations into user needs and user behavior are noticeably deemphasized, however. Though such investigations may be implied by some of the topics listed, none explicitly calls for it. If the auditor's work is to assist the user in evaluating the quality of the material presented, then the auditor's criteria must inevitably be drawn from the needs and concerns of those users. Difficult and complex though the area may be, it must be explored. Both auditors and accountants could profit from extensive research into this area. I hope it will not be ignored, for to me it represents an ultimate authority in guiding future decisions. It may require patience and humility as well as wisdom and care. Perhaps it may even result in a new *Journal of Unsuccessful Research in Accounting and Auditing,* but we must start.

Abstract vs. Natural Research Methodology

I was pleased to see that the paper takes time to discuss research methodology, particularly research design, as a separate issue. An adequately planned and executed research design is of considerable help both in making observations and in making inferences therefrom. Research design establishes the framework for the test. It is through its implementation that the researcher attempts to answer the problem posed and to control variance. We have already alluded to the importance of a properly formulated problem and how it may be approached. Research design should help to answer the problem as validly, objectively, accurately, and economically as possible. We have not, however, said much about control of variance—the major technical function of research design.

Control of variance usually refers to changes in the dependent variable. The research endeavors to isolate, as much as possible, the effect of the independent

variable in question. The researcher tries to minimize, nullify, or eliminate the influence of all other variables that might play a role but which, for one reason or another, are not of interest at the time. It is through the relative ability to control variance that Carmichael arrives at the traditional classification scheme of research design.

It should be made clear, however, that the researcher must be aware of variables at work that might influence his dependent variable under any type of research, if he is to be able to say anything about his results. In this sense, theory must precede *all* forms of research. It is true that under abstract conditions, the researcher builds the experimental environment, while under field or natural conditions, he must accept much of what already exists. It may, however, be a rather sweeping generalization to state, "in the natural setting, there is less precision in the measurement of variables and less certainty that research results are attributable to a particular variable."

Nevertheless, under either condition, the researcher is dealing with less than the whole. Selective perception in the natural setting can be just as destructive of validity as can the failure to secure correspondence with reality in the abstract setting. To say that "when abstract settings are used, the researcher must incorporate theory in the situation before data are collected . . . [while] . . . when using natural settings, the researcher collects data and then incorporates theory as he interprets the data" is to me another distinction which could be misleading. Under either condition, theory can provide guidance for identification of variables and control of variance in advance of observation and *should*, to enhance our confidence in our results. As Poincare noted,

> It is often said that experiments should be made without preconceived ideas. That is impossible. Not only would it make every experiment fruitless, but even if we wished to do so, it could not be done.[18]

Perhaps an alternative distinction might be between those conditions under which the researcher can observe the action of the independent variables and the dependent variables' response, and those under which the action has preceded the observation and the researcher must impute the relationship by retrospection. There is a significant difference between these two cases, as in the latter there was no chance for the researcher to exercise control of the independent variables and a hypothesized relationship can therefore be asserted with probably less confidence than under the former conditions.

Control is crucial if we are to have confidence in research outcomes. Without it, as Professor David Green has said, "The results *cannot* be illuminating; interesting perhaps, but not illuminating."[19]

Conclusion

One of the ironies of research in auditing—to me—is that a group which proclaims some interest in objectivity and which pretends some expertise in evaluating control, analyzing evidence, and enhancing credibility should have such a poor track record in research. Mautz and Sharaf showed us our potential. Hopefully, Mr. Carmichael's program will lead to an era of joint cooperation of academician and practitioner that will result in significant, new, and reliable

knowledge about auditing, about those who practice it, and especially about those whom it seeks to serve.

Footnotes

1. Fred N. Kerlinger, *Foundations of Behavioral Research,* New York, Holt, Rinehart and Winston, Inc., 1964, p. 11.
2. "The Crisis Over Disclosure," *Business Week,* April 22, 1972, pp. 56-59.
3. A. N. Whitehead, *An Introduction to Mathematics,* New York, Holt, Rinehart and Winston, Inc., 1911, p. 157.
4. Leopold Bernstein, "Whither Accounting Research?" *The Journal of Accountancy,* December, 1965, p. 36.
5. Robert S. Lynd, *Knowledge For What?* Princeton, N.J., Princeton University Press, 1946, p. 180.
6. *Ibid.*
7. "The Crisis Over Disclosure," p. 56.
8. H. Justin Davidson, "Research in Accounting," *The Journal of Accountancy,* September, 1968, p. 47.
9. R. K. Mautz and Jack Gray, "Some Thoughts on Research Needs in Accounting," *The Journal of Accountancy,* September, 1970, p. 57.
10. R. J. Chambers, "The Anguish of Accountants," *The Journal of Accountancy,* March, 1972, p. 71.
11. Mautz and Gray, *loc. cit.*
12. Committee to Study the Establishment of Accounting Principles, *Establishing Financial Accounting Standards,* American Institute of Certified Public Accountants, 1972, p. 31.
13. Mautz and Gray, *op. cit.* p. 55.
14. *Ibid.,* p. 56.
15. J. Buchler, ed., *Philosophical Writings of Pierce* New York, Dover Publications Inc., 1955, p. 18.
16. M. Cohen, *A Preface to Logic,* New York, Meridian, 1956, p. 148.
17. John Dewey, *How We Think* Boston, D. C. Heath & Company, 1933, p. 115.
18. H. Poincare, *Science and Hypothesis,* New York, Dover Publications, Inc., p. 143.
19. David Green, Jr., "Evaluating the Accounting Literature," *The Accounting Review,* January, 1966, p. 54.

8

The Problem with Auditing Is . . . .
(The Stuff Dreams Are Made of)

Marvin L. Stone
Stone, Gray and Company

Most of the other papers delivered at this symposium commence with the word "toward," e.g., Toward Standards for Statistical Sampling, Toward Standards for Materiality, Toward a Philosophy of Auditing. Apparently our chairman had no wish to go "toward" further problems in auditing when he assigned my topic. Consequently, my talk may be described as "untoward." I have thought a great deal about my topic since I received the assignment—so much in fact, that it has found its way into my dreams. Before addressing myself formally to the topic, let me describe a few of those dreams. My dreams are seldom, if ever, in technicolor. Everything is in sharply defined black and white—no gray areas, as in real life.

Dream No. 1—Independence and Fees

The scene of dream number one is a courtroom in which Ralph Nader is presiding judge. As my dream commenced, I was on the witness stand and was being asked to describe the CPA's role. The questioner was a not-too-friendly banker who frequently questions the CPA's independence. In all candor, his question was a little more pointed—something like, "What the hell *do* you auditors do, anyway?"

Casting aside my well-known reticence to speak before an audience, I delivered the following carefully prepared extemporaneous remarks:

> The business community in which all of us live and work is very much like a giant football game. Businessmen play the game. The SEC and we CPAs are the officials—the only difference being that the SEC has a whistle, but the CPAs don't.
>
> The public, watching from the stands, relies on the officials to see that everyone plays by the rules—the same rules. The rules are written to permit a little deceptive ball-handling, designed to fool competitors on the other team, but not to prevent the spectators from determining how the game is going—who is gaining ground and who is losing.
>
> Many of the onlookers don't even know what the game is all about. They just came along to watch because that's what everyone else was doing.
>
> Everyone watching the game is entitled to know that the gains and losses of all the players are measured against the same yard markers.

They are entitled to expect that first-down measurements are all made with the same ten-yard chain, and that all players are battling over 36-inch yards. Even the best binoculars don't provide an observer in the stands with vision equal to that of a person on the playing field. That's why officials are needed.

Its the very nature of things that occasional disagreements arise between the players and the officials. Rule enforcers seldom win popularity contests. And, of course, a few shouts from the stands of "Kill the Ump" are in the best American tradition. In our case, whenever anyone sees an infraction which escapes the official's view, the shouts come out, "Where was the Auditor?"

Like officials at other games, the officials in this game of business are rarely accused of dishonesty, I am happy to say. One hears an occasional derogatory comment about our eyesight or intelligence, but then the right to call an Ump blind or stupid is also part of our American Heritage. Once in a while a particularly incensed spectator may even question the legitimacy of our birth. Unpleasant as it is to hear epithets such as these, all of us—officials and players alike—must grin and bear it. For if the public didn't buy tickets to the game—i.e., if they didn't buy stock in the companies whose statements we audit—there would be no game.

While many of the spectators may just come along for the ride, the majority have a vital stake in the outcome of the game. They have placed heavy bets on one team or another. It's up to the CPA to give those who have a stake in the game the best possible data with which to evaluate the teams.

Naturally, I expected applause, or at least rapt attention interrupted periodically by chuckles of amusement at the cleverness of my analogy. Instead, the judge and jurors exhibited an attitude of obvious skepticism as they shook their heads in disbelief. When I looked closer, I noted that each of the jurors was also a bank loan officer. In fact, it began to look like a Robert Morris Associates meeting.

The examining counsel continued his questioning:

Q. In this football game of business, Mr. Stone, how does it happen that each team hires its own referees?

A. Traditionally, every firm has always had the right to engage auditors (and for that matter, all types of professional advisors) of its choice. The right was questioned during Congressional hearings which preceded passage of the 1933 and 1934 Securities Acts. When a spokesman for the accounting profession was asked at that time who audits the auditors, he replied, "Our consciences."

Q. You're supposed to be independent of your clients. Isn't that right, Mr. Stone?

A. Yes, that is correct. Our code of ethics contains strong rules designed to insure our independence, both in appearance and in fact.

Q. How can you be independent of the client who pays you? Doesn't his right to discharge you in favor of another auditor impair your supposed independence, both in appearance and in fact?

A. No, not at all. We are governed not only by our consciences, but also by a growing body of official pronouncements which provide guidelines to eliminate at least part of the potential areas of disagreement. The possibility that some agrieved party might sue for damages un-

> doubtedly acts as an additional safeguard against the auditor's succumbing to client pressure. As you probably know, no member of the auditing firm may serve as an officer or director of the company to be audited, nor may any member own any interest whatsoever, either directly or indirectly.

My questioner obviously considered my answer somewhat lame and not altogether responsive. He continued by saying:

> Your profession seems to have taken great pains to avoid *minor* infringements of actual or apparent independence. For example, you can't audit a company if even a few of its shares are owned by the wife of one of your partners in Seattle or Miami because *that* might make it appear that you aren't independent. Yet you consider your independence unsullied by the fact that your entire relationship with the client depends completely on his willingness to re-engage you and to pay your fee.

Although these comments weren't framed as a question, I took the opportunity to comment on the growing feeling that the public is really the CPA's client and to describe the AICPA's 1967 statement urging corporations to appoint audit committees composed of outside directors to nominate auditors and to receive their reports. This led to the following additional questions:

Q. Is this AICPA statement binding on anyone?
A. No. It's merely an advisory statement.
Q. As a matter of fact, isn't it true that this advisory statement has had very little effect on publicly held companies?
A. I believe some corporations have adopted the recommendation, but I don't know how many.
Q. How would this recommendation affect the thousands of companies that have no "outside" directors?
A. It would have no effect.

Taking a somewhat different tack, the questioner asked:

Q. Mr. Stone, a minute ago you commented that the CPA's real client is the public. If that is so, why are auditors' reports addressed to the company, its board of directors, or its stockholders? Why not "to whom it may concern" or simply no salutation at all?

After pondering the question for a few moments, I was tempted to quote Tevye, the impoverished dairyman in "Fiddler on the Roof," who when asked to explain one of his people's traditions says, "You may ask, 'Why do we wear our little round skullcaps?' Well, I'll tell you—I don't know."

However, since I had been billed as an expert, I felt obliged to burble a few ill-chosen words to the effect that the apparent inconsistency was merely evidence of the dynamic nature of the accountant's world. I agreed that different wording might well be more consistent with the auditor's present relationship to the public.

At this point, my lawyer took advantage of the rather liberal procedural rules which pervade my dreams and warned me in a stage whisper that eliminating the traditional salutation from the auditor's opinion could well lead to a further deterioration of the *Ultramares* doctrine which requires a greater degree of care by CPAs to their clients than to third parties who have no privity. Easing

the seeming distinction between clients and third parties could serve to accelerate that trend.

Then, in a typical display of what for want of a better term I will call "lawyer other-handedness," he said: "But on the other hand, the *Shatterproof Glass* decision may have already buried *Ultramares*." Once again, I yearned for a one-armed lawyer.

Having been thus forewarned (if not forearmed) by my lawyer, I turned my attention back to the examining counsel. He concluded his interrogation with one more salvo:

> Q. Mr. Stone, if, as you say, the public is your client, should not your pay come from the public? After all, he who pays the piper calls the tune.

Before I could respond, I was dismissed and James Needham, a member of the Securities Exchange Commission, was called to the witness stand.

> Q. Mr. Needham, would you describe your professional qualifications.
> A. I am a Certified Public Accountant, and was engaged in the practice of public accounting for a number of years before appointment to the SEC.
> Q. Is the SEC considering the issuance of a recommendation that outside directors nominate the corporate auditors?
> A. Yes, the Commission is considering such a proposal. In its present form, the recommendation would not have the force of law. If adopted, it would amount to a strong nudge.
> Q. Could you tell us why the SEC is considering this move?
> A. We've become concerned about the quality of work performed by many accounting firms. In fact, I've suggested that accounting firms might find it beneficial to reevaluate their current large outlays on professional development in light of the actual audit performance. The SEC has found instances of problems relating to elementary disclosure, succumbing to obvious pressure by clients, faulty judgments and decisions at the partnership level of the certifying accounting firms, and questions of independence bordering on commercial fraud.

After James Needham stepped down, the examining counsel summed up by saying:

> When life insurance companies want to know whether they should bet on my survival, they don't ask *me* to hire a doctor—they send me to theirs. The same thing happens when I apply for a job and the employer requires a physical examination. Perhaps its time for someone other than the contestants to hire the referees in the game of business described by Mr. Stone.

As my dream faded out, I kept hearing the song from the "King and I" in which the King of Siam, musing on what to tell his son and heir about women, and life in general, wonders aloud if he should educate him in all the ancient lies. Then, frustrated at the indecision fostered by his new-found modern knowledge, the King sings: "When my father was a king, he was a king who knew exactly what he knew."

As the King says: "Is a puzzlement!"

Dream No. 2—Audited Forecasts

The second dream I would like to tell you about again found me on the witness stand. This time, however, the examining counsel was a well-known financial analyst. His questions went something like this:

Q. I use financial statements to help predict the future. If you insist on using historical costs, why don't you at least give me a projection for the next year or two?

A. Management is hesitant to divulge its plans, since to do so might aid competitors.

Q. Management must have prepared a budget and cash forecast. Why can't we see them?

A. Management would rather not answer for differences between predicted and actual results. Not only that, unscrupulous managements could adjust predictions to further their own aims. Over-optimistic predictions could be used to generate short-range increases in stock prices. Overly pessimistic predictions could be made public in order to cause actual results to look good by comparison. From the data in an annual report, readers can construct their own forecasts.

Q. What you are giving us then, is a kind of "do-it-yourself kit." That arrangement doesn't seem very efficient. Management and its accountants have the best grasp of the pertinent facts and are most knowledgeable about future plans. Yet they withhold the very data we users need. What kind of full disclosure is that?

Even in my somnolent condition, I recognized this as a rhetorical question to which no answer was expected. Counsel continued:

Q. Do CPAs audit budgets and other forecasts?

A. CPAs often assist clients in preparing budgets and forecasts; however, we don't audit them. Our ethical rules prohibit the expression of an opinion on forecasts.

Q. Why the prohibition?

A. CPAs traditionally report on data that is susceptible to objective tests. Forecasts are based on opinions as to future events. An evaluation of the likelihood of such events occurring and of their probable results necessarily must rely largely on subjective evidence.

Q. You say CPAs aren't permitted to render opinions on future events. Isn't a historical statement full of assumptions about the future? Isn't your examination of receivables and the related provision for uncollectible accounts explicitly directed toward future collectibility? Isn't your examination of inventories concerned primarily with future saleability? Isn't it true, Mr. Stone, that future recoverability of unamortized plant and equipment costs is one of your principal concerns when examining fixed assets? Similarly, isn't future recoverability of primary concern when you examine capitalized research and development costs?

You say that CPAs render opinions only on objectively determined historical costs. Frankly, it seems to me that the line between the past and the future is hazy indeed. In fact, Mr. Stone, isn't it true that the "going concern" concept which underlies the financial statements of every business entity is, in effect, an implied opinion as to the future?

Suppressing a mischievous desire to ask that the question be repeated, I again assumed the question to be rhetorical. Mistaking my silence as a sign of tacit agreement (or at least the absence of any objection) my interrogator continued:

Q. We only consult history to shed some light on the future. Since auditing purports to be a utilitarian art not an academic exercise, why do CPAs audit history but not budgets?

My recollection of how this dream ended is somewhat hazy. I recall examining counsel repeating the last question over and over with ever-increasing insistence. I remember wondering why my lawyer failed to come to my aid by objecting to the questioner's haranguing and argumentative line of inquiry, until I noticed that the presiding judge was one Lewis Gilbert.

Should any of you wonder how this dream sequence ends, a midnight snack consisting of a liverwurst and smoked oyster sandwich on rye and a bottle of beer will produce an instant replay—at least, that's what induced the original.

Dream No. 3—Management Advisory Services and Independence

I seem to have tuned in late on the next Dream, so I didn't catch the questioner's name. As the dream opened, I was again on the witness stand and questioning was already underway. This time, the questioner was speaking in a pleasant, disarming way, with a hint of New York in his voice. He was humming a tune that I couldn't quite place. His questions began:

Q. Mr. Stone, you were saying that audits often result in recommendations to the client.
A. Yes. Most CPAs consider the suggestions for improvement of a client's operations the most important result of an audit—certainly the most tangible.
Q. Are CPAs often engaged to render management advisory services as a result of the recommendations contained in the so-called management letter?
A. That depends somewhat on the nature of the CPA's expertise and his ability to convince the client that consulting services are needed and that the CPA is the most logical supplier of those services. In many instances, CPAs *are* engaged to render the services recommended in a management letter.

Examining counsel continued in a friendly vein:

Q. Could you give us some examples of these services?
A. CPAs are often engaged to improve a client's accounting system or even to install a completely new system. We advise clients how taxes may be reduced by choosing the most beneficial accounting methods for such items as depreciation and inventory valuation. We occasionally assist clients in revising their financial structure to improve working capital or to facilitate expansion. Clients sometimes need help in deciding to buy or lease needed equipment or real estate. CPAs can be useful in that area as well.
Q. Aren't you being too modest, Mr. Stone? I've read that CPAs contribute to client profitability. I've heard them described as a vital part of the management team. Don't CPAs often play an important role in merger, sale and acquisition negotiations?

I cast my eyes downward, blushing slightly, and kicked my foot to the side diffidently as I uttered some modest phrase like, "Aw shucks." Then I proceeded to describe in some detail a few of the more imaginative consulting services I have performed during my professional career. I must confess that even the retelling itself became somewhat imaginative as I warmed to the task. I was feeling positively eloquent by the time I finished.

The euphoria into which I lapsed was interrupted by my questioner. With a sardonic smile on his lips and a somewhat more insistent tone in his voice he asked:

> Q. After performing these many and varied services for your clients, Mr. Stone, are you still independent to report to the public? Can you look objectively at the outcome of a transaction you helped structure? Can you judge the fairness of data accumulated by a system you designed?

Jolted out of my blissful state, I started to collect my thoughts in order to frame a response. The judge, Malcolm Devore, gave me a short respite as he leaned down from the bench to remonstrate my questioner: "One question at a time, Professor Briloff, one question at a time." As I heard my questioner's name, I suddenly remembered the name of the tune he was humming. It came from "The Mikado" by Gilbert and Sullivan and is called, "I Am the Lord High Executioner."

Having regained my composure, I delivered the profession's traditional response:

> A. In consulting engagements, CPAs merely advise; decisions are made by the client.

Judge Malcolm Devore listened with obvious sympathy to my reply, but Professor Briloff was so busy conferring with his co-counsel, Professor Schulte, that he didn't seem to be paying much attention to my answer. The moment I finished, Professor Briloff was back on his feet asking:

> Q. Shouldn't a CPA insure his independence, both in fact and in appearance, by refusing to perform consulting services for audit clients?

I responded with the "party line":

> A. Any such policy would deprive the client of advice from the person best qualified to give it. Forcing the client to engage a multitude of advisors spreads responsibility and diminishes efficiency.

In rebuttal, Professor Briloff commented, "Mr. Stone, your response sounds like an indictment of a separation-of-duties doctrine which is the very cornerstone of every system of internal control."

I was delighted that the judge relieved me of the obligation to reply by ruling Briloff's comments out of order. As the dream ended, the jury foreman (who also turned out to be Malcolm Devore) was applauding Judge Devore's decision.

Dream No. 4—General Acceptance vs. Fairness

I will recount just one more dream before getting to the subject of my talk. This dream opened in a courtroom where the bailiff was intoning the familiar,

"Hear ye, hear ye, this court is now in session in the case of General Acceptance vs. Fairness, Judge Henry J. Friendly presiding." Again, I found myself on the witness stand. After the usual preliminaries establishing my professional qualifications, the examining counsel, Wilma Soss, proceeded as follows:

Q. Mr. Stone, the standard opinion rendered by CPAs contains the phrase, "generally accepted accounting principles." Could you tell the court by whom these accounting principles have been generally accepted?

A. By preparers, users and auditors of financial statements.

Q. How do CPAs learn of this "general acceptance"? Does some organization take a periodic poll?

A. The Accounting Principles Board, an arm of the American Institute of CPAs, surveys accounting practices on a continuous basis. As a result of this surveillance and an extensive program of research, the APB issues opinions from time to time. Among other things, these opinions delineate which accounting principles are acceptable and which are not.

Q. Has the APB issued opinions on all or substantially all of the principles which underlie financial statements?

A. No, the body of principles is large and continues to grow as conditions change. Consequently, the APB, its predecessor, The Committee on Accounting Procedure, and the Financial Accounting Standards Board which will soon replace it could never hope to finish the task. The APB and its predecessor have tried to devote their resources to those areas most in need of attention.

Q. I understand that alternative means have evolved to portray various segments of accounting data. When that occurs, Mr. Stone, which alternative gets the APB's blessing—the method with the most followers?

A. Not necessarily. While the APB has attempted to narrow and reduce differences, you should understand that several alternative accounting methods may be considered generally accepted in a given situation, even though they may arrive at different results.

Q. When several acceptable accounting methods are available, which method does the accountant use in a given situation?

A. Hopefully, the one which results in the fairest presentation of the facts.

Q. Aha! You said "fairest presentation." That's the first time that you have said anything about fairness.

A. Fairness is the ultimate aim of all the APB's efforts. General acceptance is merely a means to that end.

Q. Isn't it true, Mr. Stone, that some of the accounting methods in general use fall somewhat short of the fairness standard you describe?

A. I suppose so. However, the APB is trying to weed out the inferior methods.

Q. A moment ago, Mr. Stone, you said that "hopefully" an accountant will use the accounting method which results in the fairest presentation. Isn't the auditor required to insist on the fairest alternative before he expresses an opinion?

A. No, there is no such requirement at present. However, CPAs often exert their influence in favor of the superior method. Perhaps some day the use not only of generally accepted accounting principles but

also of the most desirable GAAP will be required before an auditor renders an opinion on financial statements.

Q. On the subject of the auditor's opinion, Mr. Stone, the standard language somewhat confuses me. You CPAs say that statements "fairly present . . . in conformity with GAAP." That phrase could have several meanings. It could mean:

a. The statements are both fair *and* in conformity with GAAP.
b. The statements are fair because they are in conformity with GAAP.
c. The statements are fair only to the extent that GAAP are fair.

A. Your confusion is understandable. A special AICPA committee
Which of these meanings does the CPA intend?
urged some years ago that terms such as "present fairly" and "GAAP" be defined. A survey by Professor Briloff of selected members of the accounting profession and of the financial community showed support for each of the interpretations you mentioned and a few others as well. AICPA literature appears to take the second approach, i.e., "present fairly" is modified by the "conformity" portion of the full phrase.

A fair presentation is to be understood within the framework of GAAP, much as the behavior of football players is to be understood as "fair" within the framework of the rules of football. Just as what is fair in football may not be considered fair in other forms of social activity, meeting tests of fairness within the framework of GAAP does not guarantee meeting such tests from the standpoint of users of financial statements. This interpretation of the phrase might be called the "ground rules" theory.*

Q. Does the "ground rules" approach have the widest support among the members of the accounting profession and the financial community?

A. No, the Briloff survey showed a preference for the first interpretation. This is an understandable reaction from the financial community, but a somewhat surprising reaction from CPAs since it is the least favorable from the legal liability standpoint. Incidentally, for some years, Arthur Andersen & Co. worded its opinions: "Present fairly . . . *and* were prepared in conformity with generally accepted accounting principles," which also infers a meaning similar to the first interpretation.

Q. With so much disagreement among CPAs themselves as to the meaning of key words in the standard opinion, is it any wonder that people outside the accounting profession don't know what an auditor's opinion means?

A. The accounting profession has worked long and hard to improve communication with the public. The profession unquestionably still has a long way to go. Since fair presentation of data is clearly the accountant's major goal, it may well be that the term, GAAP, will prove to be a mere way-station in the evolution of the auditor's opinion. The term may well disappear in time, taking with it many questions of semantics which now bedevil writers and readers of CPA opinions. Should this come to pass, the issues raised in this dispute between "general acceptance" and "fairness" will become moot.

---

* See "'Present Fairly' and Generally Accepted Accounting Principles," Geraldine F. Dominiak and Joseph G. Louderback III, *The CPA Journal,* January, 1972, pp. 45-49.

I quickly learned how the judge felt about the matter when he instructed the jury that the critical test in determining if financial statements are false or misleading is whether they fairly present financial position, *not* whether they conform with GAAP. Before a decision was reached, the trial was interrupted by the clarion call of my alarm clock, arousing me to another day of toil in the vineyards of public enlightenment.

Unfortunately, problems with auditing don't stop when I awaken. Here then are a few more of the problems with which auditors must wrestle, awake or asleep.

Need for a Better Defined Philosophy of Auditing

Some years ago, Mautz and Sharaf published an excellent monograph on the philosophy of auditing, a subject on which Bob Mautz will further expound tomorrow. While this work is a good start, I am certain that the authors did not intend their pioneering efforts as a final word on the subject.

Neither auditors nor their clients seem to have a clearcut understanding of the auditor's role. In the area of fraud detection, for example, this uncertainty is evidenced by the fact that many audit procedures seem designed almost entirely to detect defalcations even though auditors continue to deny any responsibility for fraud detection. For many years, the public ascribed occult powers to auditors. Auditors were generally believed to possess near-magical powers to ferret out misdeeds merely by passing their hands over a set of books. Although auditors knew full well that no such magical powers existed, they somewhat enjoyed the effects of these widely held misconceptions and did little to dispel the mystique. Ony recently, have auditors—prompted by a rash of lawsuits—attempted to bring their public image into better focus.

The trueblood Committee's findings (re: the objectives of financial statements) could be a prelude to a similar study of audit objectives. Such a study might well provide a better exposition of just what an audit is, for whom it is performed, etc.

Need to Recognize Auditing as a Discipline Separate from Accounting

Since CPAs have traditionally audited financial statements, the line between accounting and auditing is not at all clear. This haziness is further enhanced by the fact that our reports are traditionally expressed in accounting terms. The need for a better delineation of auditing as a separate discipline is becoming more apparent as CPAs are called upon with greater frequency to audit non-financial data and management performance.

The fuzziness of the line between accounting and auditing has been particularly evident in the protracted attempts to re-word the short form auditor's opinion. Part of the difficulty may, of course, be attributed to a natural reluctance to change. However, the main problem lies in the lack of a theoretical underpinning for the entire field of auditing. Without basic theory, it's no surprise that audit procedures are in a rudimentary stage of development. Drawing inferences from a sample has long been a major technique of auditors. Yet the use of scientific sampling methods to insure validity and permit establishment of confidence levels is only recently making headway among auditors. Many CPAs still view statistical sampling as "organized superstition."

For auditing to come into its own, it must be severed from accounting and stand on its own theoretical feet. This move is particularly important if CPAs expect to be acknowledged as auditors of non-financial data, an important development in my opinion.

By way of example, the decennial census provides data upon which a great many people rely. The census, then, is an obvious candidate for independent audit. Were a CPA to undertake such an engagement, he would quickly find just how intertwined accounting and auditing really are. Few of his questions concerning theory, procedure, or form of report would be answered by any of the present auditing literature.

Need for Current Value Reporting

Without reiterating the current value arguments which were presented at the 1970 Kansas University symposium, historical cost creates problems for auditors, too. The auditor's function is to add credibility. No amount of auditing can make incredible statements credible. To most readers, I fear that the implications of historical cost statements are just that—incredible (and unintelligible, to boot).

My firm audits a company which made a sizable investment in two parcels of land ten years ago. Last year, the value of one of these parcels dropped substantially below cost. The write-down converted the company's already meager earnings to a loss, causing a stockholder to dispose of his stock.

The following year, the company sold its other parcel of ground at a gain which exceeded earnings for the last ten years combined. What do I tell the selling stockholder when he asks such questions as:

> Did the company really make all that money in one year? If not, how come the last nine years showed so little gain and even a loss last year when the other parcel was written down to market value?

How credible did my audit make those financial statements?

Financial Statements Give Erroneous Impression of Precision

The language and dollar amounts which appear in financial statements convey a much greater degree of precision than can be justified. In many respects, the accountant acts like the head linesman in a football game. After unpiling fifteen or twenty players, the referee places the ball approximately where he feels it belongs. Then the head linesman runs in with the chains to see whether the ball is one inch short or two inches beyond the first down line. So it is with accountants. After approximating the amount of receivables which will be collected, the resulting estimate is shown as $614,319.23. Nowhere is the reader put on notice that the accountant is only 95% certain that the receivables total 10% more or less than $614,319.23. If that is the degree of the accountant's certainty, shouldn't the financial statements say so?

By stating earnings per share as an absolute amount of dollars and cents, that commonly used index is invested with a much greater degree of precision than any knowledgeable insider intends. Might not this aura of precision be laid to rest if earnings per share were stated as a range rather than as an

absolute amount? The use of a range might also lessen the impression of absolute accuracy which readers now obtain from financial statements.

Need for Audit Research

Until recently, there has been virtually no research as to the effectiveness of audit procedures, reflecting auditing's general position as the accounting profession's poor relation. While vast sums have been committed to accounting research and the work of the APB, only meager resources have been committed to auditing. Except for statistical sampling, audit procedures have largely been developed by doing rather than by empirical research.

It's time to subject generally used audit procedures to critical examination. Just how effective are receivable confirmations, inventory observations, etc.? The accounting profession might well take a hard look at what went wrong when companies with robust statements, recently audited, suddenly go bankrupt. For example, if receivables turn out to be non-existent, perhaps CPAs should rethink the audit procedures which failed to uncover the problem. Perhaps research might uncover better audit procedures.

None of these comments should be interpreted as criticism of the recent revival of the Committee on Auditing Procedure. That committee's present schedule could hardly be called "too little" even though it certainly came much "too late."

Accountants' Financial Responsibility

There seems to be a growing interest in the CPA's financial resources. During a recent meeting, a banker put it quite succinctly. He asked: "You say that CPAs are unlimitedly liable for their work. What assurance does that give a financial statement user? Are CPAs bonded? Is there any place we can determine the extent of a CPA's assets or insurance?"

It is inevitable that the SEC will soon be asking similar questions. A suggestion, heard infrequently in the past, that CPAs publish their own financial statements, was recently repeated by John Burton, newly appointed Chief Accountant of the SEC. The size of an audit fee vis-a-vis the CPA's total income or resources could well bear on the question of the CPA's independence.

Shortly after World War 1, so the story goes, the King of England sought advice concerning his country's perilous financial condition. A consultant supposedly advised him to put India in his wife's name. The uncertainties of public accounting and the soaring cost of liability insurance have prompted many CPAs to take a similar route. Acceleration of this trend could serve to accentuate the public's concern over the CPA's financial responsibility.

Perhaps the public's new-found concern over the accounting profession is a sign that we have arrived. At least now we are noticed. The CPA's increased prominence brings to mind the old story of a man who, having been tarred and feathered, was being ridden out of town on a rail. When he was asked how he felt about his predicament, he replied: "If it weren't for the honor, I'd rather walk."

Reporting Requirements Burdensome to Small Business

Although most reporting requirements are equally valid for both large and small companies, a few rules are obviously geared to the needs of publicly held

companies. At present, reporting requirements apply equally to companies of all sizes. Complying with certain of the reporting requirements (e.g., reporting earnings per share) can sometimes prove burdensome to a closely held company —a burden which produces meaningless data. It's time that each accounting and auditing pronouncement be scrutinized to determine whether or not it should apply equally to public and non-public companies.

Promulgating Auditing Standards—A Problem of Coordination

Inherent in many APB announcements are a number of practical auditing and reporting problems. Even though the Committee on Auditing Procedure and the APB are both arms of the AICPA, there appear to be some coordination problems. When the APB's functions are taken over by the new Financial Accounting Standards Board, a completely independent entity, the problems of coordination are likely to increase.

Here are a few examples of the hot potatoes with which the Committee on Auditing Procedure has dealt in recent months. At least in some cases, the problems have been magnified by the APB's unwillingness to expand its general pronouncements by including more specifics.

1. APB Opinion 20 prevents a change to a less preferable accounting method. This first raises the question as to what accounting method is preferable in a given situation. Furthermore, it places the auditor in a somewhat awkward posture when one client changes to a preferable method of accounting while another client, in identical circumstances, continues to use a less preferable method. The CPA must give a clean opinion to both clients so long as consistency is maintained by each. In effect, the CPA is expressing an opinion that the second client is reporting in a manner which is "consistently unpreferable."
2. APB Opinion 18 prescribes the equity method for subsidiaries in which the parent owns 50% or less where the parent exercises "significant influence." Here the APB has attempted to suggest a reasonable guideline by stating that 20% or more ownership will normally be considered "significant." Auditors may expect considerable client pressure against the equity method when a 25%-owned subsidiary loses money. On the other hand, contrary pressures may be expected when an 18%-owned subsidiary shows excellent earnings.
3. Similar problems arise when consolidating financial statements. Where the subsidiary reports on a different fiscal year than the parent, which statements of the subsidiary should be consolidated with the parent? The SEC permits consolidation with subsidiary statements prepared within 93 days of the parent's closing date. The APB, however, has not been that specific. This leaves the auditor with a serious problem. Should the parent consolidate with audited financial statements for the subsidiary (which statements could be as much as eleven months old) or should more current unaudited financial statements be used?

Comfort Letters

I had intended to report to you on an interview with an investment banker concerning comfort letters. However, his teeth were chattering so from the "cold

comfort" he's been receiving from auditors' comfort letters that I couldn't understand him. Consequently, let me close with a few unusual applications of statistical sampling.

Statistical Sampling

I am told that a major life insurance company, seeking to speed up payment of death claims, decided to use a computerized statistical model to forecast when policyholders' claims would come due. In this way, the company hoped to virtually eliminate the need for filing claims. Those policyholders who received payments of "death" claims were somewhat startled and began to wonder whether the insurance company knew something they didn't know. However, few complaints were received from these policyholders. Major complaints came from widows who upon filing claims on the death of their spouses received a computer-produced form letter stating that their husbands were not "statistically dead."

A large department store, seeking to speed up its monthly billing procedure, devised a computerized model of its business. Feeding in historical data concerning the buying habits of each customer, the computer could then produce monthly bills without becoming bogged down by the need for posting each individual charge slip. Customers were merely billed an amount equal to their historical purchases for a given month. The store was finally forced to abandon the system, not because it received many complaints, but primarily because charge business tripled when details of the new system leaked out. Describing the experiment to his superiors, the innovative controller who had devised the new system said that he had good news and bad news. The good news: just as predicted by the system designer, even a tripling of charge business put no strain on the billing system. With no increase in office personnel whatsoever, the same bills were mailed monthly to charge customers as before the volume increase. The bad news: the department store was experiencing difficulty in paying its suppliers. The controller suggested that even this deficiency could be resolved if all suppliers would adopt the same billing system.

Despite the difficulties experienced by these two companies, my partners and I decided to experiment with statistical sampling in our accounting practice. Other practitioners assured us that statistical sampling prevented over-auditing and provided, at the same time, an acceptable confidence level. We reasoned that if statistical sampling can work on a client-by-client basis, why not for our entire practice? Consequently, we now audit a meticulously selected random sample of our clientele, before rendering an opinion on *all* of our clients. Naturally, we bill all clients—to avoid any charge of unethical conduct. Let me now recall, as best I can, one final dream—really just a catnap—that occurred shortly after we adopted this new modern approach to auditing.

As this dream opens, my six partners and I are standing before Judge Walter Mansfield just before sentencing. I never did hear the charge, only the jury's verdict. Oddly enough, the judge was dressed in the ceremonial robes normally worn by the Emperor of Japan and was singing an excerpt from the Mikado, one of my favorite Gilbert and Sullivan operettas. Translated into English, his song went something like this:

"My object all sublime,
I shall achieve in time,
To let the punishment fit the crime,
The punishment fit the crime."

With this brief preamble, the judge announced the sentence: the seven of us were to be arranged in random number order (using the last three digits of our respective social security numbers) before a firing squad of 21 guns. [I remember thinking what a shame that my first 21-gun salute was also to be my last.] Each gun, though equipped with six chambers, would contain but one bullet. In this way, the judge stated that he was "95% sure that 82% of us would survive—give or take 10%."

As we were remanded to the sheriff's custody, the judge said that he would have acquitted us had the case been tried before him without a jury—a statement which relieved all seven of us greatly.

In closing, I say to our chairman, the arranger of this excellent symposium, that I am delighted that he asked me to talk about problems, not solutions. And to all of you . . . pleasant dreams!