Edited transcript of roundtable discussion of auditors' responsibilities and capital markets, May 11, 1976: Section I

Ross Institute

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SECTION I

EDITED TRANSCRIPT
OF
ROUNDTABLE DISCUSSION ON AUDITORS' RESPONSIBILITIES
AND CAPITAL MARKETS, MAY 11, 1976

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THE AICPA'S COMMISSION ON AUDITORS' RESPONSIBILITIES
ROUNDTABLE DISCUSSION ON AUDITORS' RESPONSIBILITIES AND CAPITAL MARKETS
MAY 11, 1976

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ROUND TABLE DISCUSSION ON AUDITORS' RESPONSIBILITIES AND CAPITAL MARKETS

May 11, 1976

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Opening Remarks, Michael Schiff

Welcome to this session, which for the Ross Institute is the third session of this type that we have had this year. We have sort of experimented with this mode of discussion and found it most desirable. It is the kind of discussion that does not have formal papers presented but, instead, addresses issues with some variation in structuring before we start and then forces the discussion amongst interested parties. The session today is jointly sponsored by the Ross Institute and the AICPA's Commission on Auditors' Responsibilities and addresses the problem of the interface between the audit function and various facets of capital markets, portfolio management, and investment decision making.

You will notice that we have microphones and that the proceedings are being taped. We here at the Ross Institute will prepare and publish a report from these taped proceedings and disseminate it to interested parties. I want to assure you that there will be no attribution of comments. I suspect we couldn't do it if we tried. I think I would know what George Sorter said and a couple of others—voices I'm familiar with—but for the most part I would have great difficulty. I would ask you to please note that the microphones are situated
through the room. We can avoid pushing a microphone around if when you speak you speak loud enough so we can hear you across the room. If you try to bear this caution in mind, your gems will be recorded and we will save ourselves a lot of effort in this regard.

We have attempted to structure this session by assigning two key topics to be discussed this morning and two this afternoon. For each of the topics we have asked a person to take the responsibility of not presenting a paper, but rather, in outline form, indicating some specific questions. You will receive a copy of the outline as we proceed to each of these topics, and the individual responsible for the outline will then, perhaps, expand on the questions. We will then have it open for discussion.

Let me briefly outline our arrangements and timing. We will have a break this morning. Since we use this room both for our discussion and our luncheon, we will cut promptly at twelve. We will have refreshments in the nice room next door and then return here for lunch. At about 1:15 p.m. we will stretch for about fifteen minutes while the room is being cleaned up, reconvene at about 1:30 p.m., and then have a break at three o'clock or so of about five minutes, reconvene, and cut promptly here at 4:30. I say cut promptly at 4:30 the formal discussion. There will be refreshments available at
4:30. You may stay as long as you want and exchange ideas informally in our refreshment room down the hall.

Now, I would like to turn the meeting over to Doug Carmichael, who will chair it for the morning. Lee Seidler, who may be delayed, will chair the afternoon session. Again, I am delighted to have you here. And I turn now to our chairman for the morning, Doug Carmichael, whom you all know of course.

IMPLICATIONS OF THE EFFICIENT MARKET THEORY FOR INDEPENDENT AUDITS

Chairman of Morning Session, Douglas Carmichael

During the past several years a lot of attention has been devoted to research primarily in finance on the relationship between accounting information and security prices and the earnings generating activity of companies and really the relation of all those things to the securities market. In the last couple of years, more attention has been devoted to the implications of those theories for the development of accounting principles. Very little attention, though, has been given to the implications of those theories for independent auditors and the function of the independent auditor in society or in the capital market. So, the purpose of this roundtable is to provide a vehicle for exploration of those implications. We are really not concerned with exploring the validity of the various theories or going into great detail on the research behind them but are interested in just having a very free-flowing
discussion on what the implications of those theories are for independent auditors.

Now, both of the people that we asked to prepare outlines for the session this morning are dealing with the efficient market hypothesis. I will pass out the outline Bob Kaplan was kind enough to prepare for us and then just turn this over to Bob. His discussion is going to be divided between a brief background on the efficient market hypothesis and then an exploration of questions concerning its implications for auditors. He has identified a few questions. We don't need to be limited to those, but I think we can start there.

Outline: Prepared by Robert Kaplan

I. Background

A. Efficient Market - Market prices fully reflect available "information" and, hence, market prices react instantaneously and unbiasedly to new information

1. Weak Form - "Information" = past sequence of prices; autocorrelation studies, filter rules, uselessness of technical analysis; implication for pricing marketable equity securities.

2. Semi-Strong Form - "Information" = publicly available information; effect of stock splits, secondary offerings, macro-economic indicators; anticipation of earnings announcements, effect of switching accounting alternatives

3. Strong Form - "Information" = publicly available plus insider information; profitability of mutual funds, insider trading, segment-based earnings projections
B. Portfolio Theory

Investors should hold diversified portfolios; no risk premium for diversifiable (unsystematic) risk, linear relation between return and systematic risk, Beta (covariance of security return with market return) as a measure of systematic risk.

II. Implications of Efficient Markets for Auditors: Some Questions

A. Since prices react instantaneously to new information, should the auditor be involved in major company announcements to insure that the announcement is consistent, free from bias, verifiable,...?

B. Since the market appears to be able to absorb, in an unbiased fashion, the financial information generated by companies and their auditors, should there be a greater responsibility for auditors to exercise more judgment in disclosing information? Auditors have unique and perhaps monopolistic access to internal company information not available to the general investing public. Should auditors comment on the appropriateness of the depreciation method, assumed depreciable life of assets, and residual value of discretionary expenditures, such as R&D, advertising, and personnel development?

C. Many new disclosure requirements are arising for firms, including replacement cost estimates and forecasts. The market will apparently try to anticipate and respond quickly to this information. What should be the auditor's role in validating these data and commenting on the procedures and assumptions used by management to prepare these estimates? This is a similar question to the role of the auditor in interim statements.

D. (Courtesy of Bob Elliott) If we accept that market prices respond quickly to new information, then unusual price activity in a stock could be a signal of major events affecting a firm. Should auditors maintain in real time a market model for all the publicly traded stocks of their clients? (A market model attempts to explain movements in an individual stock by its historic correlation with overall market movements; e.g., when the market changes by 5%, the
stock is expected to change by 6%). With such a market model for each client company, auditors could detect when new, firm specific, information is being processed by the market. Should auditors attempt to discover the nature of this new information on an interim basis to perhaps issue a new or revised opinion? Would such unusual price activity during a year cause auditors to intensify certain audit procedures at the year end audit?

**Discussion Leader, Robert Kaplan**

A lot of this discussion is based on a paper I delivered at Duke University back in December, and Doug has seen fit to keep me in line by having invited both discussants of that paper at that time to this conference, Bob Mautz and Chuck Werner. So, I am sure that they will be prepared to limit me if I get out of line here.

Let me just spend a few minutes talking about what the basic ideas behind the efficient market research are and what its implications are.

In the outline under Item A, I gave a brief definition of what we mean by a market that is efficient / that it fully reflects available information, information which could be defined in various forms as shown in the subheadings of Item A, and that market prices react instantaneously and unbiasedly to new information. There is some question as to what we mean by instantaneously. I would say that still it really hasn't been settled, but I would say measured within days, one or two days, rather than within weeks or months. It is a matter of timing. Unbiasedly means that the market basically understands
the announcement or the economic event that has occurred and it attempts to adjust for that, working out as best it can the implications for the future of the economy or for the particular stock. It does not mean that the market is prescient, that it knows exactly what realizations will occur based on the new information, so there is still a lot of fluctuation that can occur. But unbiased means that there are no important dependencies; the market doesn't systematically overlook implications in the information that would enable someone to develop a trading strategy based on the time it takes for the new information to ripple through the market.

There is a certain model around the street, I guess, which says that first insiders or tape watchers get the information and certain trades get made on that. Then, the information gets down to the brokerage houses, and the brokerage houses convey it to their retail customers. It takes a while for the information to be disseminated. If that were really true, there would be an opportunity for the tape watchers to trade on the information as it ripples through all these users, but in fact, we have yet to find instances where that has actually occurred. The evidence is that, to a reasonable approximation, the information is quickly incorporated into current prices—within a day or two—and has no important dependencies that remain.

So, there is a variety of studies that have taken place on macro events—whether it is announcements of new car sales,
announcements from the Federal Reserve Board, even announcements of major world events as typified in headlines of newspapers. The idea is to find out what the speed of adjustment to that kind of information is, and again it is within a day, maybe two days. It is hard to pin it down exactly. George Benston was telling me last night at dinner that the study the people in Rochester are doing measured the adjustment time in minutes. Well, I haven't seen it. It may be true. We are going more to time compression rather than to expansion. So, that is the speed of response.

The other question is: What type of information is the market using? The first form of the efficient market idea has to do with the question: Can the past sequences of prices be used to predict future prices? An extreme example of this is technical analysis, where people chart the movements of stocks over time, try to look for certain underlying patterns. They talk about support levels, psychological barriers, all these arcane, almost astrological concepts that can take place. The efficient market, again, really implies that all the information about past sequences of prices is already incorporated in the current price and that how it happens to get to the current price is irrelevant. All the history from the past prices is already contained in the current price, and therefore technical analysis is really not a worthwhile—socially worthwhile—activity unless
you get some psychological pleasure from doing that rather than playing chess or playing tennis and other recreational activities. There are some implications there for accounting policy, particularly in the pricing of marketable equity securities, but that is really another story, not what we are going to be taking up today.

The more complicated form of the efficient market idea has to do with more general types of information, which not only include prices but the whole array of information that comes out about the economy and about stocks and industry—information about the accounting numbers, information about, say, new car sales, labor contracts, new oil discoveries, all the kinds of specific information that does come out. Again, it has been found in a wide variety of studies of this kind of information that it is incorporated in the stock price quickly and unbiasedly, that the market seems to understand what these announcements are and their implications for the future of a company or an industry. The specific kinds of accounting studies that have come up to look at this have first tried to determine the information content of earnings numbers, the role of accounting numbers. The paradigm here is that if the market is incorporating all publicly available information about the future of a company then: Is accounting data relevant to that? Are the processes that are gone through by accountants relevant to the underlying economic events of the firm? So, they
try to determine whether there is some correlation between the earnings announcements and movements in stock prices. It turns out that that is not a trivial task because the market forms expectations about what the earnings should be. Therefore, having an earnings number which says the earnings are $3.40 and trying to see whether the stock price was expected by having that earnings announcement, depend upon how that $3.40 compares to what the market had expected earnings were going to be in that period. So, one has to build models as to expectations about what the market expected earnings would be and then make judgments as to whether that particular earnings announcement was either good news, so the stock would go up, or bad news, in which case the stock might go down. Well, these models have been built, and, to summarize, the studies in this area show that if one knew the earnings announcements a year in advance or if one knew quarterly earnings announcements, say, 3 months in advance, one could develop a trading strategy that would enable you to outperform the market. So, there is some information content in the earnings numbers that is consistent to some degree with the underlying economic events of the firm. Those findings gave us all comfort that we were not doing something irrelevant.

Another set of studies had to do with the question: Is the market fooled by the particular types of accounting conventions that firms use? I might contrast the efficient
market idea with its polar extreme—which is the stupid market, perhaps, concept—and I come to think of it as the price-earnings ratio fixation. That is, the view that each company is somehow given a price-earnings ratio in the market, however determined, and then anything that a company can do to increase its earnings will then immediately translate to an increase in price because the same price-earnings ratio will be applied to those earnings regardless of how those earnings were generated. And so companies that switched from accelerated depreciation to straight line depreciation for financial reporting and therefore increased their reported earnings by 20% would be able to get, at least or at most perhaps, a 20% increase in their stock prices as investors kind of lost track as to where that extra 20% of earnings came from and applied the same price-earnings ratio.

To see whether companies are able to increase their stock prices by switching accounting policies, we have examined the depreciation issue—to switch from accelerated to straight line—and the switch in inventory policy. I have recently completed a study on whether using pooling of interests rather than purchase accounting in mergers tends to increase the stock price of acquiring companies. We have been unable to find any real evidence to the effect that companies are able to increase their stock prices by use of an accounting convention whose effect is to increase their reported earnings. Remember, in
something like the pooling vs. purchase issue, when there is a merger, there is a proxy statement; there is full information disclosed about the acquiring firm, about the acquired firm. One could compute the book value of the acquired firm and determine the value of the securities that the acquiring firm is giving up—the market value. So, even if that merger was treated as a pooling of interests, there is plenty of information for people who, if they wanted to feel that the purchase method was the correct method to use, could figure out what the goodwill was in that merger, divided it by 40, and make an annual charge, if somehow they felt that was appropriate. So that is the kind of data on which the, say, semi-strong form has been tested, basically alternative accounting policies and then certain other events of a firm as I have indicated in the outline—stock splits and secondary offerings. The evidence is consistent with an efficient market.

Now, we have kind of drawn all these implications from these studies, assuming that the market is efficient with respect to all available information. We have not really tested it on very complicated types of information processing—the kind of things that a sophisticated financial analyst might do taking annual reports and really doing projections as to future revenues and costs, publishing that information, and seeing whether such an analyst is able to affect the stock price based on the analysis of publicly available information. There have been
some studies as to following the advice of brokerage houses to buy and sell, and basically you find that brokerage houses don't outperform the market. You find that whatever information they have is already incorporated in the current stock prices.

The second major idea is portfolio theory—and I guess Marty Gruber will talk about that this afternoon—but it is just that we feel that the investors should hold diversified portfolios, which means 20 or 25 securities at least. By doing that, a lot of risk which they would be exposed to if they only held 2 or 3 securities could be diversified away, and the only risk that they are left with is the risk of what the overall market is going to do. And that is a risk that you can't get away from once you hold those types of securities—equity securities. You can hold securities that go up less when the market goes up and consequently go down less when the market goes down. But the idea is to hold diversified portfolios, given that the market is basically efficient and securities are fairly priced with respect to available information, and don't spend a lot of time and money trading out of that portfolio—paying transactions costs. In effect the buy-and-hold strategy will work quite well or as well as most any other and perhaps better than an active trading strategy in giving you an overall rate of return.

In summary here we can say that even for the naive investor, who doesn't understand all the footnotes in financial
statements, the naive investor is facing a basically fair game. This is somewhat analogous to how I learned thermodynamics. The first law of thermodynamics says that you can't lose because there is conservation of energy. The second law of thermodynamics says that you can't win—that is the law of entropy; you can't get all the energy out in the form you want it in. The efficient market, the efficient market idea says, first, that you can't win—you can't turn abnormal returns based on analysis of publicly-available information or trading on past sequences of prices, but, if you hold diversified portfolios—and if you don't have enough capital to do that on your own—use an instrument like no-load mutual funds, then you don't lose too badly. You don't lose. You are still facing a fair game, if for whatever reason you are holding securities, you still manage to hold a diversified set of them and don't spend too much of your capital paying the stockbroker and trading on them.

Now, the direct implications of these ideas have been clear to me for accounting policy—and that is really the subject of another talk—and Doug has asked me to try to think about what are the implications of the efficient market idea for auditors. And that is something I had not thought about very much and even after I thought about it some, was hard pressed to think of many ideas. I suspect perhaps the most interesting idea, which I put in as Item D, was one that, when I finally thought about how I ever got that idea, I remembered Bob Elliott
suggested it to me and I even dug out the letter when he wrote it to me. So I had to acknowledge his help on that.

I guess Items A and C are basically the idea that since the market is responding quickly to new information and is trying to incorporate new information into current security prices, should the auditor be involved with major company announcements, so that, in effect, the market is operating on data that you might call harder, less subject to bias and manipulation by management? Would there be any advantage of having the auditors involved with major company announcements, or reviewing them, so that as the market processed this data, you could have more confidence that the data were prepared in a reasonable and fair manner? So, in Item A I just mentioned any major company type of announcement—a new contract, a new discovery, labor negotiations. Item C is really the more traditional role of the issuance of financial information, such as replacement cost estimates and forecasts of future earnings, of which the market should be inclined to incorporate in its estimates of the value of the firm. What is the auditor's role in these types of disclosure?

As to Item B—let me try to make a little more sense out of what I was getting at there—I think I was addressing the sophisticated user and that is, that the market, on the margin, has prices set by sophisticated users who seem to be incorporating all the available information in security prices. So, rather than worry about how to make the current 10 or 12 page
financial statement simpler for the naive user, I think the message of the efficient market is that, well, the naive investor is already facing a fair game, and the question for auditors is, how can we make the game even fairer or increase the prospect of better allocation of resources by supplying more information that might be relevant in the setting of security prices?

Perhaps we should use the auditor as the vehicle for getting more information out to the market, for example, rather than just deciding whether the depreciation policy is consistent with GAAP, perhaps, the auditor should decide whether it is reasonable for the company or whether the depreciation lives are reasonable for those assets. An example of this, I guess, is the IRS proposal that airlines amortize their airplanes over 12 years rather than 6 years. For those of us that fly, we spend a fair amount of our time flying on 707s which are probably fully depreciated; yet we still fly on them, which means that they are getting some economic use out of them. So perhaps some of the lifetimes that companies are assuming may be too short; maybe they are too long. It is hard for the general public to get a feeling for this. Auditors do have unique access to the information. Should they really get involved in trying to get a better estimate of some of these subjective quantities? This again will create much greater demands on the auditors because it is not just deciding whether a particular mechanical procedure is consistent with the set of mechanical
procedures that are allowable but whether that mechanical procedure is appropriate for the underlying economics of the firm. And that requires more knowledge about the firm and the use of their assets in the course of business.

Item D says that the market is really responding very quickly to new information. So, maybe the auditor should try and figure out what information is there, so that the auditor does not consistently overlook a relevant piece of information when the audit is conducted. Or, if there has been a change in some assumption that the auditor made in the last audit report, the auditor perhaps should discover this and issue a revised opinion or withdraw the opinion that was last issued. So that if all of a sudden, the stock had dropped 20 to 30 per cent, there clearly must be some new information about the value of the assets of that firm, the long-term assets or perhaps the inventory, and it may be possible that the auditor should try to find out about this.

The idea here is that the auditor would keep track of the market prices of the firms and try to detect when there has been unusual price activity in a stock and then try and determine what is causing that unusual activity. This means unusual activity over and above the market. If the market drops 20% and a stock drops 20%, you know that that is a statement about overall economic conditions and forecast about the future, a general not a specific thing. But if the market had dropped 5% and that particular stock
had dropped 30%, then somehow the market is receiving information that says that a security is really worth much less than I had previously thought and may call into question some of the asset valuations that had formerly appeared on the balance sheet, and that may give a signal to the auditors to find out what has happened and to determine whether that would cause them to change their opinion about this company since their last financial statements.

That is kind of a brief overview of the ideas as best as I can make it as to what implications the efficient market might have to auditors.

GENERAL DISCUSSION

Chairman (DRC): Now, I suppose the easiest thing to do would be to take several of these in order, starting with the first.

Discussion Leader (RK): Yes, if there are any questions about No. 1, which is the efficient market...

Chairman (DRC): After that comprehensive explanation, how could there be questions?

(LL): On your one, we were not supposed to challenge the basis or even get into it, but I am curious. Have there not been instances in history which have indicated that the market has been carried away by itself—tulip bulbs in Holland?

Discussion Leader (RK): Well, the tests that have been done have been done on the equity market, on the New York Stock Exchange securities basically since 1930 or 1933, and it is not a statement that goes back in history to the tulip bulbs thing.
One of my colleagues did a study about prices of greenbacks in the Civil War, which were issued by the North, showing how the prices of that really fluctuated very much with the success of the Union Army and could identify the turning points, and the same idea of risks and portfolio models shows that it was consistent with that kind of model, even though they didn't have computers and never heard the words regression or Beta.

(LL): Getting back, you know, to a little more recent history, was the market completely efficient when institutions, say, bid up the price of the magic 50 or the growth stocks with enormous high multiples that don't seem to be existing any more?

Discussion Leader (RK): You get a lot of stories about things like this, two-tier, three-tier market, or the conglomerates, where ex post it seems like the market was wrong. Remember the fact that the market is efficient doesn't mean that it is prescient, otherwise we wouldn't have much fluctuation in prices. It is hard to know what the expectations were about the future growth in the economy and future inflation rates. Changes in the rate of growth of a firm affect growth stocks much more than nongrowth stocks. One can build simple finance models that talk about the value of the firm as a function of the increase in growth in the dividends. A reduction of the growth rate of 20% can have severe impacts on what we call high flyers, high PE multiple stocks. So, changes in that expectation of
growth can have really substantial impact on the top 50, the high-growth stocks, much more than on the low-growth stocks. As we hit the oil embargo, became more conscious of limited or higher cost of raw materials, then we could have revised our expectations about what growth could be expected and that would cause a re-evaluation back down. One could think of explanations that would be consistent with the market price at that time, that would be consistent with the efficient market idea, but other people could also say: "Well, the market was stupid; it is obvious that the prices of those securities could not be supported by the underlying fundamentals."

(LL): Only one other question. This gets close to accounting. You mentioned that the research had touched on purchase vs. pooling, and I presume that is under the new rules. Did you go back to the middle and late sixties?

Discussion Leader (RK): Well, no, we went back and looked at mergers which took place between 1954 and 1964.
(LL): Did you really? I have always believed that there were instances where the public was pretty badly fooled about the price that a company paid for an acquisition which was treated as a pooling.

Discussion Leader (RK): We didn't look from '65 to '72, which is when many of the typically larger poolings occurred. But given that we didn't find anything from '54 to '64, one would have to argue that somehow the market forgot how to keep track of poolings later after it was doing a good job the previous ten years. As far as the price that they paid, that is another story. There is some evidence that the way you make gains is to own a company that was being brought out, not to be the company that was doing the buying. There were gains associated with owning a stock which was acquired by another firm, but, you know, the pooling vs. purchase idea is that somehow the acquiring firms could get higher stock prices or higher rates of return, because they were understating their true earnings by use of poolings. We looked and couldn't find it.

(CW): You have got a little bit of a bias on most purchase vs. pooling studies, because inherently the companies that tend to have purchase after purchase after purchase are the stronger companies to begin with. As I recall some of what you told us down at Duke last year, it is a little bit hard to take that kind of a factor out of those studies.
Discussion Leader (RK): But it is interesting that certainly those companies don't seem to be hurt by the use of a purchase method with an amortization. So, that if I had to choose one set of companies whose stock prices seemed to go up with the merger, it was the purchase one, perhaps because they were the stronger ones.

(KJ): Bob, could I ask a question? I'm a little confused by the term efficient. Does efficient merely mean, as it is used in the title of this theory, does it mean merely that the information is absorbed, or that the response is a proper response?

Discussion Leader (RK): Both. Instantaneously and unbiasedly is where the fault lies.

(EH): How do you decide whether a reaction is unbiased?

Discussion Leader (RK): Well, you have to have some prior model as to whether a piece of information is an important economic event with the firm. For example, a stock split with no change in dividends is one that we consider not an important economic event. It would really be surprising to find that the market placed a higher value on securities that were
selling at $30 a share rather than $90—previous set—at $90 a share. In fact you find just that; the market is basically indifferent to a stock split. This gets into a lot of examination of the details of the studies, and how it was tested, and it is obviously a hard thing to construct situations where one can have strong prior feeling as to what the appropriate or unbiased price of stocks is and then see whether in fact that was realized on average by companies. But I think that would get us involved in another discussion.

(EH): Except that it is very very important to an understanding of the theory to know—and I'm not proposing that you go any deeper than you feel that you want to—but it is extremely difficult to understand the significance of the theorem, unless one understands especially this matter of bias, as to how that is judged.

(JR): Is it correct to say, Bob, that...unbiased relates to the reflection of information available from whatever source in the market? But now if you assume that some sources are costly to seek out, I have a question in my mind whether that costly information to seek out is in fact reflected depending on the cost of seeking out the information. In that case, unbiased, in the empirical sense at least, would mean that prices only reflect the information that was sought out by the market, and I suspect there is no way to empirically
find out whether all information was sought out, including information that was costly. In that case, I think this may have some different implications to the discussion that follows.

(MG): There is a very practical definition of unbiasedness which is simply that you can't make money by trading on the information. Not necessarily that an adjustment is right at any instant in time, but there is as likely to be an over-adjustment as there is an underadjustment in any moment in time. So the point comes up where the simple trading rule, such as when a company has earnings—reports earnings—which are higher than last period's earnings, buy. That type of rule does not lead to excess returns. Not necessarily again that the market adjusts with no variance, adjusts perfectly, but it doesn't really adjust in one direction.

(CW): Yes, but you see, you haven't done any studies that concentrate on those situations where there is a confluence of the thing like hot stock and hot accounting, like franchising 6 years ago. You haven't concentrated on a study just of that kind of thing.

Discussion Leader (RK): Well, there are lots of information that the market uses to set security prices, and it has only been tested on a subset of those, perhaps a small and simple subset. I try to at least make that clear in my survey article. We expect that the market does a fairly good job even
on the more complicated kinds of information, though there may be anomalies. I'm not prepared to say that I know for sure that when all is said and done 10 or 20 years from now, that it will have worked on all these kinds of processing of information, but I think it shifts one's beliefs. One can no longer believe that the market is really stupid and it only concentrates on earnings per share and that it therefore reacts to anything you can do to affect earnings per share, depending on how it is classified. Based on the smoothing studies that Joshua has worked on, one would think differently about that kind of view of the market. One would think that the market is more sophisticated than just responding in a Pavlovian fashion to earnings per share announcements, that is, that it is conditioned about what the price-earnings ratio is and will automatically increase prices as earnings per share increases by whatever means. So, if there are market inefficiencies with respect to data, it will be of a fairly complex form and very complex interpretation of publicly available data.

(HK): Commenting again on Mr. Werner's example of the franchising company, fast food companies, it was amazing during the early years of those companies that they went to the market recording income almost entirely from franchise fees, which obviously had to come to an end sooner or later, and little or nothing from operating income. Now, was the market efficient
when it sold those stocks at big prices and couldn't evaluate the net income—the quality of that income?

Discussion Leader (RK): We are much smarter ex post than we are ex ante. It is easy to see that what happens is that there is competition and firms enter and that you don't want a franchise store—carry out food store—on every street you know, corner in the United States. But, you don't know where the high stock price is coming from. One would think that the market was there responding to the earnings growth caused by franchise sales. A similar thing happened with computer leasing companies. Now, how much of their earnings growth was caused by just the purchase of assets and its impact through the investment tax credit, so that you got growth in earnings just because they were purchasing equipment? Now, was the market really fooled by that, thinking that was an operating sustainable income? Again, the casual evidence is that it was. It has not been tested, and there is always the danger of looking ex post at a few of the more spectacular reversals of stock prices and saying that the market was really foolish and not realizing the great mass of transactions which basically did a reasonably good job. Any process with uncertainty is going to be something in detail. If you, ex post, select those and say that was really evidence the market was stupid, you are guilty of some bias.
(HK): You realize that there are a considerable number of cases of what you call anecdotal evidence, which the market seems to have been inefficient in recent years.

(MS): I think we are still struggling with the definition of efficient. Can we come back to our definition?

(LL): Is there a question of the efficient analysis of false information, which gives you a false answer, although there is an efficient analysis?

(JR): Maybe it is important in all this to at least recognize that all the evidence is really on the average. We are talking about empirical aggregated data on many companies. So, there may be a lot of anecdotal evidence about 1 firm, 2 firms, 10 firms, here and there, different points in time. The empirical evidence which exists with respect to unbiased efficient response is really an aggregate evidence. Now this doesn't really necessarily mean—and I don't think that any of the research conducted so far has borne this out—doesn't necessarily mean that there wouldn't be some individuals fooled in the process of adjustment, some individuals whose wealth was transferred to others of a short-term fashion. Now eventually, the market will win because there will be enough sophisticated analysts, sophisticated investors who will process information, not necessarily the information that is presumably false inherent in the accounting reports—which is a foolish, kind of fooling
hypothesis—not necessarily process it, but the investors who are sophisticated will go to other sources of information and process them correctly. Eventually the market will reflect this information unbiasedly, quickly, but in the process it may well be that some individuals will be adversely affected.

(GS): Plus, Bob, isn't it true that as you stated—just as an aside, but it is important here—if you could predict income correctly, I mean next year's income correctly, after some naive prediction model of what you would expect income to be and there is a difference that you can make money? So, I mean, efficient market doesn't say that you necessarily predict, that it is necessarily an all-knowing predictor. That is not implied by the efficient market.

Discussion Leader (RK): No, as I said, it is not prescient. The question that comes up is—it really gets back to franchise stock, computer leasing stock, the conglomerates—was the market really being foolish? Was there some model, or conversely, is there some model of rational expectations or beliefs that was consistent with the stock prices of those firms, so that it was only subsequently—as subsequent economic events occurred—that people realized that the securities were worth less than they had previously been set? So it is not the poor processing of information but an initial processing which gave a certain price and new information which came out which
caused the revaluation. Well, it is very hard to measure that because it is really very hard to know what the information set is at any given time and what causes revaluation. It is especially challenging, with the hindsight of 5 to 10 years, to look back and pick out the most spectacular reversals and say that well, it should have been obvious. In a way that is kind of what happened to auditor that got caught on an issue like fraud for a company that goes bankrupt. At the time that they were doing it, it kind of looked okay, and it was acceptable. We don't look at the great 90-98 percent of the companies where in fact that was okay. If you go back and look at the 1 or 2 percent that turned belly up, you say: "Well, that was obvious; the auditor was stupid to have missed that." I am just wondering whether we are doing the same kind of analysis. We are much smarter at the end of a detective story than at the beginning, and it is obvious what the clues were all through. We just kind of missed them though as we were reading it.

(CW): You point out one interesting thing that has severe implications for us. We get sued on specific cases not on the average.

Discussion Leader (RK): Let me ask George to give me some support here, or perhaps other evidence or theories to make sure I'm doing a good job on this.

(GB): I was just going to put to you a question on some
anecdotal evidence. What do you think of a stock that is selling at 20 times earnings and then 5 times earnings, fluctuates in that sense, selling for $100 and then $30 and then back up again? You can look through the stock pages of the last several years and find stocks where there is no question that the accounting is everything anyone would want it to be, yet they have fluctuated. IBM, General Motors, those where there is a tremendous amount of information, and there is no question about the accounting "fooling the public" in some sense. Why do they fluctuate so greatly? The answer is basically that the future is extremely difficult to predict, and all kinds of things change one's expectations of the future. It often comes to the point where we see a certain thing and we look at it ex post and say, "ah, it is because of the accounting." The evidence is that the accounting information that is produced has very little to do with it. It has to do with people trying to estimate a very uncertain future. Surely the franchising stocks were a bad idea when they go down but a lot of people thought that they wouldn't...I live in Rochester, and everyone used to run around saying "we could have bought Haloid before it became Xerox and been millionaires" and now they are running around saying "we could have sold Xerox" and so on. The point is that we don't know what the future is like and it is very difficult to estimate it. The evidence we seem to have is that the accounting data
that are produced by accountants have not terribly much to do with people being able to predict it.

(JR): George, are you saying that earnings have nothing to do with prediction of the future?

(GB): I'm saying that I don't know evidence that they do.

(JR): Well, earnings affect market prices. That we know.

(GB): I have no evidence that says that is true.

(JR): You are objecting, in other words, to the evidence that Bob was just discussing.

(GB): No, he didn't say that. I don't believe.

Discussion Leader (RK): Well, I said that if you know earnings a year in advance, that will help you tell about stock prices.

(GB): That isn't the same as saying earnings affect market prices. If anything, market prices affect earnings.

Discussion Leader (RK): No, the fact that you know earnings a year in advance and that enables you to develop a trading strategy to make money doesn't say that the information that eventually gets into stock prices is solely due to the release of the earnings reports. There is other information which the earnings report is correlated with so it is hard to pick out what the unique contribution of
earnings is vs. all the other information that comes out about a company and its industry. George is perhaps taking a harder line on this than I would.

(GB): Well, I am suggesting, for example, that historians don't cause wars.

(JR): No, but historians predict; accounting historians, I think, try to predict also the future. And I think earning numbers do have an element of prediction and interpretation of future events.

(GB): That is a testable hypothesis. I know of no tests that support that.

(JR): Yes, I think it is consistent with the Ball and Brown finding, it is consistent with the Ball, Brown and Gonedes work, and it is consistent with many others.

(GS): Let's take your analogy of the historian, because it seems to me that the purpose of auditors' statements and accounting information in general ought to be to serve as a filter or as a mechanism that allows one, as new events come around, as something happens in the economy or the industry, to use the history of the firm, the relationship of significant things in the firm which are contained within financial statements, to interpret or to translate this industry or economy happening in terms of its significance towards the future of a particular firm. In other words, that accounting, instead of being a value
thing or whatnot, serves as a filter, as a relationship that says, "this happens, we know this happens in industry right now, this happens in the economy." Now what we are interested in clearly, is, what is the impact of this on the future of a particular firm? Now it seems to me accounting statements, properly looked at, can serve as a way to assess the significance of something that is happening for the future of a particular firm. This is a somewhat different notion than what we have been thinking about accounting statements in the past. I think that would make sense in terms of the efficient market literature.

(DRC): What does that imply for the auditor? Should the auditor be concerned then with the framework and continue to finely tune the framework or should he move up to the new information prior to its release?

(GS): Okay, let me answer this, because I have some specific comments in Roman numeral II, where I think the ideas that Bob has generated are good. However, I would say they are much—given my theory, if you will—there are much simpler ways of dealing with them. For instance, Item A: Since prices react instantaneously to new information, should the auditor be involved in major company announcements to insure that the announcement is consistent, free from bias, verifiable, and so on? That would be almost impossible it seems to me; however, I think, given the efficient market framework and given my idea on the role of financial statements, what you ought to insist
on is a postaudit of these types of announcements, that is, to make them a part of the archives of the firm and then compare them to the actual things that happened, so that when a new announcement—in other words, a track record of announcements of this type—so that then when a new announcement comes along the public is better able to assess the credibility and the significance of those announcements, those new announcements and therefore their significance for the firm. In other words, it seems to me that it would be very difficult to audit the announcement prior to issuing it. However, it should be less difficult to maintain some sort of track record that allows the investors later on when a new announcement comes along to assess the significance and validity of that announcement.

(EH): May I ask how that could be? How could it be more difficult to reach a conclusion about information before the information is issued than it is to reach a comparable conclusion about that information after the information is issued?

(GS): Well, of course, it is a very simple thing to take a—you know, say, a president talks to a society of financial analysts and makes certain statements which are his beliefs, and so on—well, how do you audit that?

(EH): That is my question, but my question also is: How can you do it any better later than before?

(GS): Well, later on, you could say that he said that sales would go up, did sales go up? He said that this would
happen, did it happen? Those types of things I think are easier to do.

(EH): You don't need an auditor to judge whether sales went up.

Discussion Leader (RK): Ex post, the guy may have made his best estimate and those things didn't get realized. I would hate to hold them accountable for every statement they made. It seems to me that what I was getting at there is that if the president gets up there and says "sales are expanding in all our lines of business" perhaps, the auditor should see what was the evidence that enabled the president to make that statement. Was it really all the lines of business or maybe five out of eight?

(GS): But wait, I'm not assuming. Let me just finish this. I'm not saying hold them accountable in the sense that if they were off target, they were wrong. But, just for instance, if it is revealed, I would guess, that people have different sorts of character traits—some are optimistic,
some are pessimistic, and they tend to be consistent about these things—if you reveal those sorts of tendencies, if the chronicle or history of the firm shows that a certain management is generally optimistic or pessimistic, all in good faith, you know, then that is useful information. Let me just extend that to Item B, where again it seems to me—how do you test realizable lives? One of the simpler things that could be done, I would guess, to remedy the effect of Item B is for financial statements to show the extent of fully depreciated assets on hand. Well, to the extent that you have fully depreciated assets on hand, there is prima facie evidence, I would guess, that there was some error in—some wrong estimate. If some firms have a great deal of fully depreciated assets on hand, I think that would be useful information in order to... Chuck, you don't agree?

(EH): I don't disagree with that. Go ahead Chuck.

(CW): The thing is that in the real world, you know, they have all got fully depreciated assets, running to millions and billions of dollars, and a lot of the reason for that is the change in the maintenance expense cycle which occurs over time and at varying price levels.

(GS): I'm not even making a judgment. I'm saying that it is easier for the user to assess, for instance, the significance of heavy retirements in a given year, knowing that there are a great deal of fully depreciated assets on hand versus not knowing. In other words, I'm sure that they
all have fully depreciated assets on hand, but I'm also sure
that they don't all have the same proportion of fully
depreciated assets. I am not saying that they were wrong;
I'm saying that the disclosure provides information that
allows, positively allows, better prediction, if we are going
to use this as a framework for prediction.

(EH): Could I come back to a point that George made?
This matter of comparing the outcome of a forecast, which is
what you were talking about—comparing the outcome of a
forecast—with what the president said from time to time.
Now I think that the implication was that it was the auditors
who were going to do that. Also, the implication in Item B and
all through Section II of the outline is: What should the
auditors be doing? It seems to me that what we ought to be
talking about first is: What information is useful to
investors? It seems to me that, on the particular matter
of comparing the forecasts with the eventuality, fine,
that can be done. Also, if there should be a section of
information, not necessarily financial statements, in which
that kind of information is presented, that is a requirement
that could be created. But then it seems to me that we move
as a second step, or should be moving as a second step,
instead of jumping as an initial conclusion, to the
question of whether it is useful, appropriate, practicable for
auditors to be involved in that process. I'm not jumping to a conclusion that auditors shouldn't be involved in any particular process. I am objecting to what I see and hear as a tendency to move directly from the notion that certain information should be presented to a conclusion that it should be the auditors who present it.

(GB): That is not the conclusion here; I don't believe. It is a statement of: If the market is efficient, would these things be worth considering? I don't think there is any conclusion that I sense.

(EH): Well—even in raising the question—the question is raised in terms of whether it should be the auditors who do the presenting.

(JR): I think that is the auditor's function, really, if you accept the premises (1) that the market is efficient in that it adjusts to information unbiasedly and efficiently, (2) that at the same time the market is not prescient, (3) that there are possibly certain kinds of information that are not really available immediately to the market, and (4) that the firm has some information that it can usefully make available to the market. I view the auditor's function primarily as being an information source on the reliability of such information. The firm can disclose information, but the auditor's function—this I view also as a social benefit of an auditor's function—is providing information on the reliability of that information. Of course, the information on reliability of the information provided by the firm can
presumably be obtained from other sources as well, but it may be too costly. Now, it seems to me that the auditor's social function is exactly to come up with a social arrangement that provides a relatively cheap source, relatively cheap compared to other social arrangements, to provide information on the reliability of information.

(EH): Would you add "within the limits of practicability"?
(JR): Yes, I would always add that. What that means really...

(EH): That is all I would like to hear.
(JR): When you are saying "within the limits of practicability" that means when the cost of doing that is not too high.

(MFC): That is not the last word for me. I don't know what "within the limits of practicability" means. We do have the concept of "auditor of record" and the suggestion here that if the information is important it should go out promptly and that the auditor can contribute some sense of reliability. Does all this mean that he should be there all the time and should have some role with respect to all kinds of financial information that may be put out by a company during the year?

(JR): Look, there is a cost/benefit to all of this, and clearly there is a limit, not in the sense of practicability.

(MFC): That is a flash word, too.

(JR): Well, it is difficult, really, to come up with an a priori assessment. Where should the auditor stop being involved? Clearly, if at least you look at it from a macro-
social viewpoint, there is a limit to...

(MFC): I understand. I guess the first point of analysis would be to determine whether this group believes that a benefit, a real benefit, would be provided and then, I suppose to make some attempt to measure that as against the cost of providing it.

(JR): Yes, I think Item B is correct, but it doesn't go as far as to specify what should be the criterion for this. So, I think the criterion should be added, and that criterion is prediction. In other words, I think that is what is missing here because I agree with Item B completely. Where auditors can be helpful—given their relative comparative advantage in being close to the firm, familiar with the firm—in providing information disclosed by the firm is to have as an objective, in choosing among accounting alternatives or others, to enhance predictiveability.

(MFC): Are you saying forecasting is useful? Do you think that it is equally useful to have a major involvement in forecasting by auditors?

(JR): Yes, I do, because I don't think firms have incentives on their own to provide always correct forecasts.

(MFC): Do you mean that they are affected by a bias?

(JR): Yes, I think they are biased in the case of negative information; they will provide, I think, good and
correct forecasts about positive information that has positive implications to their stock returns, but they will not have such an incentive to do that with respect to negative information. It seems to me that this is where the role of the auditor should be most apparent.

(MFC): This is a suggestion, I guess, which is consistent with the recently withdrawn proposal of the SEC. Once you get into forecasting, you can't get out.

(GB): I want to make several points, speaking to George Sorter's point but also on this. There was a study done in England on the bias in forecasts, several studies as a matter of fact, and they all show that companies tend to underforecast rather than overforecast.

(CW): That's the English bias.

(GB): Yes, there is a bias in the sense that if things turn out to be better than you predicted everyone is happy but if they turn out to be worse than you predicted then you are at fault.

(MS): There is evidence on that score in internal divisional budgeting and planning methods in which there is a similar tendency to understate in order to achieve.

Discussion Leader (RK): I actually wanted to mention that in the outline. I think that the point George raised relates to Item D in the outline, the item that Bob Elliott suggested. I think that this is one that creates a paradox.
The question of auditing the company's announcements would give rise to something perhaps in the auditing statement, something like this: "We have audited the financial announcements of this company, and we find that the president has lied three times, has spoken rather loosely four times, and has been fairly decent five times." I think very few auditors would want to sign a statement like that, and, indeed, there is a question as to whether the market, that is people who have a profit interest in trying to determine that, don't do it better and faster than the auditor could do it. But this gives rise in my mind to another aspect, which is why I tied it to Item B in the outline. Look, auditors might want to do this, might want to monitor—audit—these announcements for a different reason. They might want to do it to find out whether the audit ought to be concerned with the veracity of the management with which the auditors are dealing. If you find a situation in which management is constantly—or, at least, appears to be constantly—making misleading statements, this is a management that the auditor might want to be very careful about and to go considerably further in terms of the audit than otherwise. Therefore, the auditor might find it in the auditor's self-interest to audit an announcement by this kind of an outfit so that he could get some sort of an insight as an auditor into the firm that he is dealing with, particularly insight into the management.
I think you do. You can always get an example to prove whatever you want to prove. For example, we have had one situation in which probably within two weeks of knowing what the earnings were going to finally be, the chief executive officer, unbeknownst to anyone else within the official ranks of top management, made an announcement of what the earnings were going to be, although everyone knew that the estimate was too high. It caused us a tremendous amount of trouble because his lieutenants began to try to make his predictions come true. So, instead of taking two weeks, it took about a month to fight that battle out. We finally won the battle and lost the account. There are some, I suspect, some instances of irresponsibility, but I don't know how many. What has been the experience of other auditors and maybe you, Bill? Would you say that announcements are generally made with a pretty good reasoning process or on a fairly reliable basis?

(WN): I would say this is one of the things that they think that the market is very efficient about. They think that it sizes up the tendencies of the companies, and they know—have an idea of—who tends to be optimistic and so on. There are patterns. I think that there is a basic bias toward making positive type forecasts. You don't find too many forecasts when we are going into a business recession that
say, well, "we think earnings are going to be down 40 percent this quarter" or something of that sort. They might indicate that things aren't so good, but they won't make as specific and definite forecast on the down side, as they will on the up side. As Manny said, the SEC Proposal, which was something that we proposed to the Federation, was to make companies establish a forecasting system. I think that over a period of time that would make forecasts more credible.

(MFC): I would like just to carry this point of bias a little further. Has it been your experience that there is a greater bias in a favorable, optimistic forecast as against one which is negative or, in other words, a tendency to limit a forecast on the down side, but to be a bit too optimistic on the high side?

(WN): Well, I think that on the down side the turn comes so rapidly in a business recession and the deterioration takes place so quickly that the businessman doesn't realize how quickly something is happening. That was certainly true of this last recession. So, in that sense, the forecasts that were made at the time—I don't know how many there were—probably did not state the full extent of the decline in inventories and so forth. So this is not a question of forecasting bias; it is maybe more a question of lack of knowledge.

Discussion Leader (RK): I had a student who did a dissertation which looked at releases of company forecasts,
and he found that they were pretty good in both directions. I don't think that you would find a bias one way or the other, whether the forecasts were good news or bad news. Again, it depends on what you mean by bad news. But I would say that, given that they chose to issue a forecast and that they said earnings were down below the previous year, say, you would find that that was basically an unbiased estimate, that they were not consistently underestimating the decline in earnings.

Let me get back—focus back—on these issues. It seems to me that Items A, B, and C are really talking about two different things. One issue concerns the auditor getting involved with validating currently available and released information, such as interim reports or forecasts or any other statements made by company officials. In this area, it was pointed out that perhaps there is this cost-benefit analysis and the question is: How do we know whether it is worth getting involved? I guess the more basic questions is: What is the incidence of managers issuing either misleading forecasts or sloppily prepared statements just speaking off the top of their heads without having factual content behind them? If the incidence of that is fairly low, which means that a few—a couple of—percentage of the time, maybe even less,
there will be managers who issue misleading statements and sloppy statements, then I would say there is no pressing need to have auditors get involved in that.

The point Chuck made is that you don't get sued on your portfolio of clients, you get sued on individual clients. That is true, but I think it is hard to change the legal system. I don't want to be accused of the naivete of saying that they are wrong. But from the evidence we have, people should hold diversified portfolios so that their economic fortunes are not vitally tied to one or two securities. If we make a judgment that, on average, it is not worth auditing everybody on these continuing release of statements because we use up too much resources in doing that relative to how much we save for the 1 or 2 percent that do issue misleading statements, that is a social judgment, and we shouldn't then go off and say to auditors that you should have done it. That would still be a judgment. I don't know what the incidence is of what we might call false or misleading statements or sloppily prepared statements—which is not to say in a pejorative sense that managements were evil—but just that they didn't think very carefully.

The second point raises the question: What is the auditor's role in disseminating new information that perhaps is not currently available? The kinds of things that I talked about in Item B really gets into business judgment, not necessarily just financial statement judgment. What is the effectiveness of the company's R&D program or
their advertising and personnel programs? How well are
they using assets which are carried on the books at zero value?

(HJ): Bob, haven't you got a mixed bag in Item B,
particularly the last portion? Isn't there a difference in
something such as--take the first two items--appropriateness
of depreciation method and appropriateness of depreciable life?
We have been told—and I accept it—that auditors presently
have a definite responsibility with regard to the depreciable
life of an asset but not with regard to the depreciation method
used. There are many similar things, and I think you could add
to your list here. But in one case you are talking about, perhaps,
items that involve the real world, economic reality. For
example, how long will an asset last? But you are also
getting into allocation problems here.

Discussion Leader (RK): Well, I had in mind here
perhaps even a diversion from currently accepted depreci-
ation methods. Many assets probably depreciate slower than
straight line. So, if you take present value, the discounted
cash flow concept of the value of an asset, then as I learned
from David Solomon, you might want to use an annuity method,
which is an increasing depreciation charge rather than a
steady depreciation charge or a declining depreciation charge,
to value the expiration of service on that asset over time. Even
though the asset we are most familiar with, our cars, depreciate as
soon as we drive them out of a showroom, many assets don't depreciate
that quickly, at least for company use. They decline slower; straight line depreciation may be too conservative for that company or may be too high a charge in the early years of the assets. Do we want auditors to make those kinds of judgments?

(DRC): I'm afraid to open up the discussion on accounting methods. I have observed that there is a great tendency to want to be accountants and not auditors, for some reason. I think I agree with Ernie's comment that we do seem to be leapfrogging a little too much. The first question is: Would it be desirable to present this information? There is no need to pin that on the auditor as the starting point.

I would like to explore a little further the movement of the auditor up to—closer to—the time of the release of the data. We have talked about the basic implication of the efficient market hypothesis. The idea that the market responds to information quickly leads you to the first step in saying that it might be a good idea to get the auditor involved. You offered one criterion—kind of a rough cost-benefit allocation—for further judging whether that would be desirable. You look at whether the information is in fact misleading, whether misleading information is getting issued. That is also on the demand side. It speaks to the question: Is there a demand for the service? I think there are probably several other dimensions, other than demand. I
wondered if we could explore it. Let's just accept that "yes, there is a demand, that some misleading information does get issued," and explore the implications.

(JR): In talking about the misleading information, I think it may be important that whatever research was done on the forecast accuracy it could only focus on forecasts that were issued, that were made. Clearly, if there is an incentive not to issue negative forecasts, we probably then find that the forecasts that were issued may have not had a lot of reason not to be fairly accurate. We miss from our empirical sample of data all the forecasts not issued. If you assume that the incentive is not there to issue a negative forecast, then we are looking at basically a very biased sample.

Discussion Leader (RK): That is irrelevant, because we are not deciding whether the company should issue forecasts or not. That is an accounting question. If they do do it, should there be an auditor's role in that? Is that an increase in responsibility?

Let me just indicate one other cost. I just talked about the cost of the auditor involvement. Another cost is the delay cost. If the process has to be audited in advance before the announcement, assuming auditor involvement, it could increase
the amount of time until that announcement comes out and increase the amount of leakage of information which could get into the market.

(GS): That brings up a point that I think is appropos exactly to auditing—to auditor's problems. Given the efficient market, or whatever you want to assume there, is it not probably true that if you realize that news is going to get out that the important thing, whenever in auditing there is, if there is ever, a tradeoff between timeliness and credibility, you ought to opt for credibility rather than timeliness? I think that is true because accounting statements by and large are not going to be fresh news. Therefore, their role is to establish a credibility or a verification of news that is already there and a framework for interpreting new news. Thus, whenever there has to be a tradeoff between timeliness and credibility, wouldn't an implication of the evidence be that we should opt for credibility rather than timeliness? Is that a fair statement?

(RE): The two may not be completely interchangeable. The important thing here is to distinguish between the corrective effect of the auditor and the deterrent effect. The fact that the information may have to be audited a few months
from now may motivate management to get 90 percent of the imprecision out of the information now already, so that it may not be necessary to audit it immediately.

(GS): But what I am saying is that when there is a tradeoff, it seems to me a reasonable statement to say that when a conflict appears between timeliness and credibility, it should be resolved based on the evidence of how the accounting information was used for credibility and precision rather than in favor of timeliness.

(CW): Do you mean from the standpoint of the capital market? That is clearly not the results you want when you are talking about other users, such as salesmen, who care less about accuracy and much more about timeliness.

(GS): I thought that we were talking in general.

Discussion Leader (RK): I think that what perhaps the auditor should be doing is what they do with internal control, which is to establish a system by which these public announcements get made. This would enable the auditor to feel better that there is at least a system that generates
the information that gets issued. He could rely on the system, without necessarily having to look at each particular announcement as it comes out. He ought to be satisfied that some reasonable system is available for generating information to the top management of the corporation when they go out and make all these announcements. In which case there would not be a conflict because they would be establishing a system, rather than worrying about each particular announcement.

(WN): Wouldn't having an audit provide you with that control? It is a kind of a benchmark, and a company can't afford to be way off the mark when the final figures come out. I think it has the same deterrent effect on all the other kinds of information that are issued throughout the year because the annual audit is the benchmark to which they are going to be held accountable in the long run.

(RE): Is there no need for auditor involvement in interim financial statements? The question is do managements within the period get optimistic during the first half and then have to take it in the chin in the second half? So, is the deterrent effect frequent enough, only coming once a year?

(WN): I think we are trying to improve our system of accounting for interim periods, but I don't know that you necessarily get that in an audit.
(MS): Bill, there is something that you said earlier about the analyst reviewing, whether they be forecasts or reports, and building up a kind of subjective judgment of credibility over time. Here we are talking about the auditor involvement to do something about credibility. Now, if the market is efficient and if over time you develop some measure of credibility for each firm, then why should there be an auditor involvement? Are we adding something at a cost? Will the benefit to the analyst be enhanced if he already has "efficient" appraisal of this in the marketplace, as you observed?

(JR): I think there is some evidence that quarterly earnings are manipulated—if you wish, managed, smoothed, as Bob Elliott indicated—during the first half of the year and that the end-of-year adjustments are used in order to look at the relationship and adjust the relationship between the annual and the previously reported quarterly earnings. I think this is one of the things that motivated the SEC release on interim reporting. I also think that there is some consistent evidence that this practice is being conducted. The question is whether it is being conducted enough to have any impact that would make involvement of auditors in interim reports beneficial. That is still an unresolved question.
(MS): Well, is the impact such that the market doesn't see through it as they see through changes in accounting methods?

(JR): Well, I don't think we really have conclusive evidence of whether it does on interims or not.

Discussion Leader (RK): All allocations over time involve judgment, and basically, when you are looking at interims, there is very little information. So, you don't know what to heck went on.

(WN): But you have to be careful when you are talking about the market. The market is a vast place. It includes Exxon, on the one hand, and some little bitty company, on the other hand. For instance, on interim earnings, I think that the major companies, the top 200 or 300, or even the Fortune 500, at least the top 200 to 300, are putting out pretty good information and are not consciously trying to make it look good in the first half, and then have to come to account in the second half. But as you get farther down the line where there are less controls, less sophisticated methods and so forth, that is where the problems have arisen. Those companies are not going to be subject to the same degree of SEC control. You have to make a distinction.

(JR): It may possibly be an FASB problem because Opinion 28 relating to interims provides much more flexibility in preparing interim reports than the annual GAAP. That really provides them the ability to do this when they wish to do it.
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(DRC): I don't think that Opinion 28 created any new possibilities. Ernie, do you still have a comment?

(WN): I think that there are so many constraints on trying to manipulate things, though. It isn't just the auditor; it is all the lawsuits and a whole host of things that are forcing people to try to do the best possible reporting.

(LL): I would guess that even in your respectable big companies that you have got a little bit of borrowing. In other words, they are not going to put something out that is going to prove false. But, if they expect a good third quarter and the first quarter is a cent less than they expected—because they wanted a little bit more than a year ago—I would guess that the tendency to borrow in that situation is built in, and I don't know how we would ever find it. If we tried to, say, survey for it or investigate for it, I don't know how we would ever get anybody to admit that they took what they expected to earn that year and threw a little bit in the first quarter just so it wouldn't show a down trend because they felt the whole year was going to show an up trend.

(WN): Also, if it looked pretty good in the first period, they would sock a little away in their pockets and bring it out later.

(LL): Yes, they might save a little for the next quarter; I think this exists, even in the most respectable companies.
(WN): Of course, that happens on an annual basis as well.

(LL): Yes, I agree with that.

(DRC): We should take a break. Mr. Hicks had raised his hand earlier.

(EH): Well, please don't break on my account. I am not sure if it is useful, but I am going to comment anyhow. I keep hearing things that I regard as misconceptions, and I keep wanting to react to them. Mention was made a while ago about having the auditor establish a system whereby a company would produce information for press releases; at least that is what came through to me. I had two reactions to that. One is that if a company needs a system to generate information for press releases—and it probably does—it ought to have one. And, if it wanted to turn to its public accountants for advice as to how to set one up, it probably would, but that in itself, it seems to me, is not the kind of thing we are talking about here. At least, it should not be the kind of thing that we are talking about here. We seem to be suggesting that the auditor should have a responsibility to see that the company has that kind of system. My other point is that if you talk about relying on a system to generate information for press releases, or even a system for quarterly information or whatever else, the system is really almost a pointless concept. The concept of a system is almost pointless
because problems arise when people, usually at a high rather than at a low level, decide—as they can and sometimes do—to thwart the system.

(KJ): Doug, are you going to come back to this after the break?

(DRC): I didn't plan to.

(KJ): In the interest only of getting something that I wanted to say down before we move on, I come around this way. Items A and B of the outline really deal with two different aspects of the audit as a discipline, although it doesn't come through clearly. In respect to Item B, which deals with analysis of the effects of discretionary costs and depreciation methods, I ask myself: Where does the efficient market presently get the information to make the evaluations so that it is not fooled when companies switch from one method to another? So, it is difficult for me to see that the auditor in making a contribution would do much that isn't already being done by some other group. We would be adding a cost, and I fail to see that the auditor's analysis of the effectiveness of a depreciation method or of the effectiveness of the personnel development program within a company really adds anything that would be useful, if the market is truly efficient. Now, just let me loop back to Item A. I have to take a different view than George did about the tradeoff between
timeliness and credibility—credibility was the word he used, but I think he was trying to say accuracy—it would seem to me that if there is a place where the auditor can be involved, it is in a sense of participation that is limited to something that adds usefulness to the data. Now, let me see if I can go back to that. It would seem to me that if a company were making a press release, there is a danger of a big lie as opposed to a delicate shading. I would expect that a delicate shading type of error—if you can get off that end of the scale—can ordinarily be interpreted by the market because of its efficiency, but the real danger is the big lie on the other end of the scale, where the information put out is just "untruthful." It would seem to me that if you adopt that policy, you would say, well, that the auditor will tailor what he does, not to pick up items all the way across the scale, but just to pick up maybe the top quadrant and that he is really interested in satisfying himself that a company isn't using a big-lie technique. In that sense, an appropriate limitation as to the auditor's objective, if he were to be involved, would be to add something that could be of value, as I understand this efficient market concept.

Discussion Leader (RK): Let me just say as to Ken's first point about Item B, about the efficient market. The market is efficient in what I call the semi-strong form with
respect to publicly available information. So, that when a company switches depreciation methods, that usually is noted by the auditors and the effect of the change is noted. That information can be processed by the market. As for information on inaccurate estimates of lives of depreciable assets or residual values on discretionary expenditures, that information is not disclosed. It is basically not in the market, so we should not assume that that information is impounded in current stock prices. So, what I was getting at was, perhaps, that that information is relevant and maybe we want it to be impounded in stock prices. What is the vehicle for doing that? Again, the auditors do have unique access to that kind of information and perhaps could disclose it. The fact that the market is efficient does not mean that it knows everything.

(KJ): Well, do you mean to say that the system of pushing out information in Form 10Q reports showing property additions and estimates of lives by types of assets, property withdrawals and the amount of depreciation by types of assets, and a "funds" statement doesn't really provide the information for people to make their analyses presently?

Discussion Leader (RK): Is there enough information in that so that we know all the fully depreciated assets that a company has and is using?
(KJ): I don't think that information is there, but there is some data that sometimes allows you to calculate it, for example, using a scheme something like the reserve ratio test that used to be in the IRS Code. There is an awful lot of information available, and I would be surprised if people were surprised about the improper estimation of the useful lives of corporations' assets.

Discussion Leader (RK): I don't have any hard evidence that says that they know it or that they don't know it. I was just speculating on it. Maybe they do.

(EH): If I could say just one more thing, it would be that this whole last discussion about disclosing the residual value or discretionary expenditures, as an example, seems almost irrelevant to what we are talking about here today, if what we are talking about are the auditor's responsibilities. The question there is, should generally accepted accounting principles, whose determination is a function of the FASB, should they require that that kind of information be disclosed? And I hope that around the table there is an understanding of the difference between requiring new information to be presented and imposing an obligation on auditors with respect to that new information.

(DRC): I think there is that understanding now. We should take a 10 minute break.
SOME POSSIBLE CONTRIBUTIONS OF INDEPENDENT AUDITORS
TO THE EFFICIENCY OF CAPITAL MARKETS

Chairman of Morning Session, Douglas R. Carmichael

The outline has been passed out. George has identified a number of interesting questions. We have discussed the efficient market hypothesis; I think our background on that is probably sufficient. We can now dig into the questions that George has offered for us.

Outline Prepared by George Benston

I. If the market for traded stocks is efficient, i.e., information is impounded into share prices very quickly, the data included in financial statements are not useful to investors unless:

1. some information otherwise doesn't get to the market;

2. some information is disclosed to the market only because it later would have to be published in financial reports;

3. publication of financial data acts as an incentive to managers to serve the best interests of shareholders.

What do we know or can we learn of these possibilities?

II. With respect to the stewardship function of auditing (assuming efficient capital markets) to what extent should the auditor be responsible for reporting on management's performance? Consider the following, particularly with respect to materiality and reporting to (a) the board of directors, (b) shareholders, (c) the SEC and other regulatory authorities, and (d) police authorities:
1. failure to meet contractually determined (implicitly or explicitly) fiduciary responsibilities
   a. outright stealing
   b. self-dealing
   c. less than arm's length contracts
   d. questionable behavior, including personal behavior likely to damage the image or position of the corporation

2. failure to use the resources of the firm effectively
   a. ineffective internal controls
   b. ineffective management controls (e.g., information system, production planning, market forecasts, control over expenditures)
   c. bad decision making resulting in possibly avoidable losses (query: when should this be recognized?)
   d. errors of judgment

III. What is the rationale that supports or rejects requirements imposed on private corporations that govern the extent of audits?

   1. Would the optimal amount of auditing be achieved without requirements being imposed by a governmental or private authority?

   2. If not, what are the relevant externalities and utility mal-distributions?

IV. Where there is no market for ownership claims in an enterprise, should auditing be required and specified? The following situations might be considered:

   1. partnerships
   2. corporations with relatively few owners
   3. governmental bodies (states, municipalities, authorities, school districts)

Discussion Leader, George J. Benston

I want to make an extremely brief introductory remark.

Then, I really want to talk either to this outline or to whatever you choose, so it need not be restricted to the outline. I just put down everything that I thought of, and when I
reached the bottom of the paper, I stopped. I didn't feel like xeroxing any more than one page.

Basically, I can say that I think this is a very important conference and a very important idea. But, first, let me give just some very small background information for myself, at least. When I started out in the accounting business as a CPA, I admit that I neither knew of the efficient market or, for that matter, of markets or marginal cost or any of these minor things that I learned when I went to Chicago. All I did as a CPA was to do audits and present stuff and worry about what the AICPA said I was supposed to do and, you know, the little bit of nuisance the SEC was doing. Those were the grand old days when it was relatively easy, before we learned how good Andy Barr really was. And so then, having done that, when I got to Chicago, we worried about the fact that information should be useful to investors, because everything was in terms of prediction and these data should be very useful to investors. In fact, accounting ought to be concerned with the question of investment decisions in the market because that was what economists were concerned with. We all were concerned—my doctorate is in economics, not accounting—and we all were concerned with economics. So, the whole question came up about how accounting data will inform the market in terms of making decisions. And—the auditing function—not only were we unconcerned with auditing; we didn't teach it and thought
it beneath us to do research in it because that was the grubby work of those CPAs who were out there with which academics should not soil their hands. Hard work is distasteful anyway, so we try to avoid that.

In any event, the first piece of research I did on this question in 1967 on the relation of accounting data to stock prices was not done with the efficient market in mind. In fact, the efficient market literature really didn't enter at that point, and I have to be honest and say that I really wasn't thinking about it. What I was really thinking about was: What accounting data are people using to make their decision? I guess it wasn't that clear in my mind at that time that they may not be using the stuff at all and, in fact, that there was every reason to believe that they wouldn't be using the stuff. I thought about the arguments that we used to have in the accounting workshops. George Sorter was there and Dave Green and Sidney Davidson arguing: What is it that investors really want? I think they want this because I am an investor and I represent the rest of them and this is what I think they want. And, if we argue this way, it seems to me and many other people, that what we ought to do is to see what investors want by looking at what they did: namely, when accounting data were published, what is the relationship between various constructs of that data and something that happened, namely a change in the market price of stock? That is what the research was about as I saw it.
So, I went to some effort to do this, not completely correctly at that time. What I found, much to my surprise, frankly, was that there wasn't any particular relationship. There was a small one, but not a very large one, and I expected, really expected, a large one. Other people followed after me. We found that the stock prices didn't really adjust when the accounting information became available. When you think about the efficient market—that is, if you think about the profit that somebody makes by giving information quickly and acting upon it—you then realize that, by the time the accounting data are published, it is pretty late in that particular game, at least with respect to widely-traded securities. At that point, it isn't surprising that there is no particular market reaction when accounting data are published. In fact, when I think back on it, I think, "Why the hell didn't I see that in advance?" It seems obvious now; it didn't seem obvious then, though.

What this did was throw at least my thinking back to what accounting is about, and, frankly, I have come full circle back to the days when I never thought about it much: namely, that what an accountant really is is an auditor. We are really not trying to move the markets for shares; they move, in my opinion, very well by themselves. The information we produce is not terribly useful in that sense. But what the auditor does in digging into what is going on in the firm, determining whether
the management is honest or dishonest, determining what has really happened—and the management knows that what has happened is going to be produced by independent professionals, someone reporting on the stewardship of that company—is extremely important and very difficult. I think that accounting, in fact, is not only a viable profession I think it is also socially a very important profession. Indeed, what auditors might be seriously considering are their audit responsibilities in places where there is no market, namely cities—not to cast aspersions about any particular city, of course—but cities in general, school districts, states, government agencies, and a variety of other things, where there is no market, where there is no ownership claim other than the claim of all the citizens over this. And the auditor again, being that independent professional who comes in and says this is what happened, is extremely important. So, I would sort of like to direct some of the discussion, not direct it, but suggest our movement in that direction toward some of these questions.

Now what I have listed in the outline are not things that I necessarily believe. I tried to take it from one extreme to the other to see where we might go and to get a continuum. For example, I am not suggesting that the auditor be a policeman, but it has been so suggested. Indeed, I think there are people in the SEC who believe that this
should be the case, that society functions best where every person makes sure that his or her neighbor is not violating any law that happens to be on the books. We can have such a society, and people do. But the question is: What are the costs? Now, obviously the framework in which I suggest we discuss all of this is the framework that Bob Elliott has put forth—namely, a cost-benefit framework. As a colleague once put it to me, you can have a frictionless world if you are willing to coat it with about two feet of grease. The questions are: Is it worth it? Is the trade-off between not having friction and having to wallow around in grease really something we want? We can have a world without crime if we are willing to give police enormous authority, assuming that they aren't perpetrating the crime, which is not always a valid assumption. But, in any event, there are costs and benefits to all this to the point where we have to accept a certain amount of things that we prefer not to have because the cost to do something about it is excessive, that is to say, is not a tradeoff that we are willing to have. One has to keep all that in mind, although I didn't mention that explicitly.

But I didn't want to talk a lot and I hope I haven't. What I suggest is that we go through the outline or, as I say, anything else that one wants and carry on the discussion from earlier and try to focus in on what the auditor's responsibilities are and what the function of auditing is, given what I think the state
of the world is for publicly-traded companies—namely, that the market gets information very quickly when that information is published and even if it isn't published.

There is one other thing that I would like to say aside from the costs and benefits. And that is, if we believe something may be true, we also ought to consider the questions: How can we find out? What information, data, would be consistent or inconsistent with that belief? It is simply not enough—it is important to raise the question—that we think something or other is the case. We have to go to the next step and ask, If this were the case what can we look at that would tell us that we are right or we are wrong? That is to say that we are willing to change our minds when we get additional information. Also, there are questions in which there is no way of studying the matter, and we just have to say: "It is my belief and that is the end of it. Maybe I can be persuasive."

Would anyone like to open up? I have sort of said what I would like to say here, and I would like to open it to all of you.

GENERAL DISCUSSION

(MRC): Since the focus here is on auditing, why don't we address your Item II and your offer to expand on it? I think that we should start with Item II(2) from the outline.

Discussion Leader (GB): Yes, okay, I will expand it. Again, I don't want to talk; I really don't like to open as we
have, as I saw this morning, a very intelligent, voluble group, and I don't think that you want to hear me lecturing.

(MFC): I find Item II(2) particularly appropriate and timely. Lee Layton and I had quite a discussion on this subject yesterday.

Discussion Leader (GB): Well, let me mention a few of the things here. Take the question of internal controls, the first one under Item II (2); I tried to put this out as a continuum. To what extent is reporting on stewardship, which, is after all, historically where we all started out, a function of auditing? A steward was given charge of the estate, and someone could come and say,"what did he do with those resources?" The question is one, I think, we ought to consider: To what extent does the auditor have a comparative advantage in reporting on how effective management works? The second aspect is again the cost-benefit analysis. What is the cost of doing this relative to the value of the information one gets?

(MFC): Are you suggesting a reporting requirement beyond the financial statements?

Discussion Leader (GB): I'm suggesting this is something auditors ought to be concerned with. I can give you my opinion on this, if you like.

(MFC): I am sorry; I am trying to determine if in what you are saying, you are talking about a responsibility that would go beyond the formal financial statements, or whether
you were saying that the formal financial statements should in some way reflect a judgment as to stewardship.

Discussion Leader (GB): Well, I'm suggesting that the financial statements are primarily useful as they reflect the judgment with respect to stewardship. But I don't mean to imply by that that every aspect of stewardship is worth doing; the cost of it may be excessive. I would certainly like to know as an individual stockholder, whether the managements of companies have done everything they could possibly do to maximize my wealth as represented by claims of the corporation. What I don't believe is that the auditor is capable of determining or that the cost of the auditor doing this is worth it, relative to the cost of my getting the information from other sources. So, that if we go back taking it from Item d, "errors of judgment," backwards, I can't see where the auditor has a comparative advantage in deciding whether the manager has used his or her judgment effectively in running the corporation. I think to attempt to put that into the audit function would be a very serious error. I don't think anybody would like that; well, no, clearly, somebody would like it.

(MFC): A particular consequence may be due to an error in judgment in relation to some other things.
Discussion Leader (GB): Yes. Then it is just a matter of sorting that out.

(MFC): Should the financial statements reflect the decisions?

Discussion Leader (GB): Yes. Well, I tell you, my personal opinion is that it should stop at fraud. It should stop at the manager violating the contractual agreement in the sense of appropriating the resources of the firm for his own use as against the use by the stockholders. The auditor should not be responsible for determining whether the manager has operated the firm efficiently or effectively, because I don't believe the auditor has a comparative advantage in that decision. I think a decision has to be made, but the auditor is not the person who is capable of making that. In fact, he might very well violate what is more important by attempting to get into being the second manager, which is really what we are talking about.

(RE): Then, you believe that the GAO standards, which do go beyond fiscal accountability to program efficiency and effectiveness as well as compliance auditing, are rather a full scope. You believe that the GAO is perhaps in error on that.

Discussion Leader (GB): No, not as the arm of the Government and not for government agencies. They lack the profit motive.
RE: Well, there is no clear reason to me why those standards wouldn't be equally applicable in a profit-oriented environment.

RK: It may be, but we have another standard. We do have profits and survival in the capital market. So, there is a cutting edge. Long sequences of bad decisions eventually show up, where, as we all know, there is no such mechanism in the government. And so we have instituted one, perhaps, the GAO one.

LL: Excuse me, when you said government, you meant government as the body being audited, or government as the body doing the auditing?

Discussion Leader (GB): The body being audited.

DS: Well, do you think that internal auditors can exercise the judgment that would be called for in Item II(2)?

Discussion Leader (GB): Yes, I think they could exercise some of it. I think that internal auditors have the ability to, certainly to see that the internal controls are being followed on all levels below the top levels; I don't think that they have any chance of doing it on the top and that is where the external auditor comes in.

MS: We didn't get the question here, David. Would you repeat the question on the relationship of internal-external auditing?
(DS): Yes, I'm asking what, in fact, if the internal auditors could exercise judgment on some of these things, what prevented the outside auditor from doing the same thing, if, in fact, it is desirable?

Discussion Leader (GB): Well, it is partly a matter of cost; it is a matter of what is the most efficient way of doing this? I think it has been really well determined that it is much more efficient to have this internal-external split.

(MS): Well, I think an extension on David's point would be, perhaps, not for the external auditor to do it necessarily, but to determine whether the methodology and the approach used by the internal auditor is adequate for the situation. Rather than having the external auditor do it and register an opinion on whether the judgment of the management was right or wrong, have the external auditor evaluate, ex post, the internal auditor's technique of judging managerial decision to determine whether it is adequate, so that we can therefore assume that the control is there. Now, is that a role of the external auditor?

(DS): I am not questioning whether external auditors should do these things. Let's leave that question out. You were saying that even if it were desirable, it wouldn't be practical. My question is whether, in fact, it can be done by the internal auditor?

Discussion Leader (GB): Well, as I said, it is first a matter of the relative cost of this. The question that is a part of the SAPs is whether the external auditors should
report upon the existence or non-existence of internal control. Certainly, it is well established that if the internal controls are such that the records of the firm cannot support the financial statements—and you don't know what is in the inventory and you can't find out (you can't count it all) or that you don't know where the money went—then the auditor may not be able to render an opinion on the financial statements. But then you go to the next question: What if the auditor—let's say the MAS service group—reviewed the controls and said these controls are not sufficient to run the company effectively? Let's suppose that they found that you are not making good sales forecasts, you do not have a good inventory control system in the sense that you may be overstocking or mis-stocking, and so on. The question then is, does the external auditor have a responsibility to put this in the statement? It is not now established that he does. This company doesn't have controls that would enable it to run effectively. However, this doesn't mean that the financial statements are wrong; it means that the company—from the auditor's knowledge of the company—is not being efficiently managed. Is that what reports on stewardship should include?

(LL): Manny and I were discussing this yesterday on a preliminary basis. But we had gotten beyond the financial
statements, and we were considering reporting. We were considering the question of reporting to whom? And we got to reporting to the independent directors of a company, not management itself. We had gotten a little further down the line than you did, not within the framework of financial statements, but reporting what we had found within the framework of a management letter, without the responsibility to find everything. We were really ranging quite far in this area.

**Discussion Leader (GB):** Then I would raise the question to you. Let's assume that you found all of this and you gave it to the directors, what is your responsibility as an auditor to the stockholders? What if the board of directors are not acting upon you advice?

**(MFC):** This is precisely the question we were debating yesterday. We came to no conclusions, however.

** (GS):** Manny, let me try to rephrase Item II(2) here, because it bothers me. I don't think that, with all due deference to the almost superhuman skills of auditors, we are the most expert lawyers or management experts, who can decide and evaluate what is the most efficient, or what is efficient or legal and what is not legal, and I feel uncomfortable in being thrust in the role of sort of a judge. So, therefore, with respect to failure to use the resources of the firm effectively, do we have any comparative advantage to decide
what it is—how resources are used effectively—or that there is only one possible effective way of using resources or are there many based on different cost-benefit relationships? Let me try to rephrase—possibly without making this judgmental statement—is it or can it be the responsibility of auditors (and here we get into Mr. Hicks' problem again, obviously) to make a descriptive statement to someone (let's leave that aside for the moment) about the internal controls that are existing, about the management policies—just like you now have for accounting policies, a description of accounting policies—a description of the management policies that are existing, and that in fact they are existing? In other words, a statement of whether they are said to exist and whether they are existing, without necessarily evaluating them. I'm not sure that it should be the auditor's function to say that these are the most efficient set of management policies, because there may be many, or even to say that this is the most efficient set of internal controls. You have a tradeoff in internal controls, too, between benefits and costs. But, can it be or is it possible for the auditor to be required to report to someone about what the internal controls are, what management policies are, what they are said to be and what they are? In other words, is that legitimate—and that is rephrasing it away from that sort of judging it—for the auditor to just report what they are said to be and what
they actually are?

(MFC): Isn't that to a substantial extent now going on in terms of the management letter.

(GS): Well, I think it is, to some degree.

(CW): No, not the way George described it.

(GS): Well, let me put it in terms of internal controls. Suppose we presently think a company has weaknesses in its internal control, we will do more auditing in order to satisfy ourselves with the propriety of the statements. We may make certain suggestions to strengthen internal control. But the question is, do we report the following: "The firm assumes that the following internal control procedure is in existence; this is what actually exists," without necessarily opining on whether this is the optimal system of management control? The same question arises with respect to management policies toward certain critical management actions. I don't know whether it is right for a given firm, or most efficient, to engage in making market forecasts or use one production planning system or another; it depends on the sort of variations they are willing to buy, and so on.

(MFC): What if you have a system of internal control which requires that the auditor every year to extend the scope of his audit?

(GS): That is exactly it. I would say he has to go beyond that.
(CW): Is there something wrong with that, because that might, from a cost standpoint, be the best way to do it? It might be better for us to extend our procedures slightly than for management to hire a full-time receiving clerk who would then have a function independent from the rest of the purchasing function.

(GS): Well, that is not exactly our judgment. But we should report to someone that the following internal control system exists and how that relates to what purportedly exists.

(RE): Well, the fact is, George, that we do that now and we do it for third party consumption also. Now, we don't do it on every company, but there is a model to be followed there. For example, on EDP service bureaus, it is very common, where many other people are relying on the quality of controls there, to go in, review the controls, and issue a report that says: "Here is what management says the controls are, and this is what we found to be the case."

(GS): And can that be extended to significant management policies? So, there would be a statement of management policies and a statement of whether these are in fact being followed without opining on whether these are the correct policies.

(MS): I have some difficulty there.

(HJ): Why shouldn't management, instead of the auditor, do that?

(GS): Well, certainly, it is management's report. The point is that management says that these are the policies and
it would be the audit function to determine whether these are the policies actually being carried out.

(HJ): You are in part suggesting an extension of disclosure, which, again, is beyond the purview of auditing.

(GS): I just said that I'm getting back to Mr. Hick's problem.

(MS): I'm still having some difficulty with the way we are using internal control—its definition. And also, I think it would be fair at this point—it is mentioned in the booklet—to consider to whom we report on normal reporting to stockholders and the increasing role of reporting to audit committees. Since this is on the scene, I think we might address both. But coming back to the notion of internal control, I think, based on what George submitted, we can think of internal controls vis a vis the financial report, the published report, as one group, which is the way we are doing it now. The extension that George suggests has to do with internal controls as they relate to the internal management of the business. Now, the internal management of the business deals with resource allocation. My concern is not to second guess the management, but to raise the question, is the role of the auditor one of concern with the quality of the control evaluative system internally, which then gives rise to transactions and activity, which is then audited ex post by
the auditor as he relies on the internal control system which is tied to the financial report? I think the question to be addressed under Item II(2) is, Is it a role of the auditor to examine this activity within a company? Or is it something that the auditor should walk away from and say this is irrelevant to my task because I'm concerned solely with the external reporting? And therefore ex post the matter of allocation of resources is something the auditor doesn't look at. The end result is that what he looked at he can say that that indeed happened.

(MFC): I want to put this into perspective. One of the arguments is, that financial statements fairly presented reflect the resource allocation and use, and that therefore nothing further is required. You were raising the question of whether something more is required.

(MS): Yes, I was, particularly if you think in terms of the audit committee and the emerging responsibility of the external auditor, vis a vis the obligation of the audit committee, whose charter goes beyond the mere review of the internal control system vis a vis the annual report.

(KJ): In order to think about this in a logical way, you have got to leave aside the question of to whom should the auditor report? There is some sort of bias in there. It is a political problem that suggests that the auditor can't report
on internal control because a long letter of weaknesses will affect adversely on management of the company. It is often stated this way: that people who are not familiar in depth with the company can't understand the auditor's recommendations. But I believe that the right interpretation is the first one. Leave aside who reports and then come back...

(MFC): I want to be sure that I understand you, Ken. Are you saying there is a bias there that isn't dealt with?

(KJ): I think there is a bias that gets introduced when we start talking—and it belongs in there logically—but I think the right way to explore the question is to leave aside initially who gets the report and start by dealing with the areas in which the auditor can make a contribution. We can then determine where we have skills, and then decide whether that contribution, whatever it is, is going to be useful. Only then should we attempt to decide who should get the information.

(MFC): I assume that is the range in Item II(2), from (a) to (d).

(KJ): Well, I am not sure. Let me go back for a minute and deal with the question of relevance, because I'm just astounded by Mr. Werner's comment that it may be cheaper for us to extend our auditing procedures a little bit than it would be for a company to...

(MFC): That's a little bit of his bias.
(KJ): Let me go back and put it in here, in what I think is the right sort of neutral perspective. Those that know me understand that neutrality is my hallmark. It does seem to me that the auditor, in terms of his relevance, that is, in conducting an efficient examination, has got to be concerned about (we have heard this morning earlier, credibility of management, but that really is not an issue,) but has got to be concerned about whether he has an understanding of the business affairs of the company. And we are as concerned, or a good auditor is as concerned, about whether he understand the substance of one transaction as he is about other aspects of the audit. And that is translatable in practice to a concern about the type of errors that management makes internally. Every auditor can recall from his own experience the company where the auditor walks in and in just going around the shop perceives immediately that there is an obvious problem in production control. It is important for the auditor to see it, because it has important auditing implications on inventory, on the way costs are produced, and so on. So everybody will agree that the auditor should learn about it. However, I don't think we are prepared yet to say that the auditor, having perceived it, should now go and tell someone that their production control system is bad. I think it is kind of a shyness because I think that we have information and that, we are going to be criticized if we have information and people ultimately discover that we can do it and we haven't been doing anything about it for all of this period of time, in my opinion.
(RK): I think the auditors should confine their attention to "the financial statements presents fairly," however defined. In the other areas, George's concern about the management capability and effectiveness, for example, really comes in to the use of the audit committee of the board of directors. It is really the function of the board of directors to see to it that the management is operating well. I could see the audit committee could sponsor a study either by the external auditors or by perhaps the management services people in a firm perhaps to be in a better position to judge managerial decisions and the quality of the decisions.

(MFC): I didn't mean to interrupt but the question you are raising is really a much more basic question. Whom does the audit committee represent? Whom does the board represent? Whom do the independent members of the board represent? If you accept the view that they represent the shareholders, presumably, you are then reporting to the shareholders, although they don't tell them about it. Now the question was raised earlier, I think by George, what if a report is made and nothing happens? That is the second question.

(RK): You mean a pejorative or negative report? They could finish the study and everything could indicate that management is doing okay, and they are using pretty good models, maybe not the best ones, but basically good ones.
(MFC): No, I mean not pejorative but maybe critical in some of these areas that are reported to the audit committee. Let us suppose that the audit committee finds itself incapable of dealing with it, not that it refuses to deal with it, and next time around, the auditor sees that the situation is continuing. He presumably—this is the assumption here—felt that the matters were material enough to require him to make a report. That is the way he comes out.

(RK): I don't know who is going to be so smart or who would want to be so smart in that situation. I think that the audit committee and the outside directors, who are presumably very experienced business people dealing with it, can make the judgment as to the appropriate response. I think that they ultimately bear very heavy burdens and that it is properly where the burdens should be. The auditor is being a little presumptious, I think, to say that I know it is wrong, and I'm going to tell the world, even though the audit committee won't listen.

(JR): The question here is: Do they have incentive to make always correct judgments?

(MFC): Well, they have disincentives to make bad ones, and sometimes they are very substantial. Litigation in the past two decades has demonstrated that. The point is, theoretically, that they do represent shareholders, as do
the interested directors, the officer directors. Maybe the burden is greater on the officer directors because they do have a conflict, so to speak, between the representation of their own performance as against what the shareholders understand. But let us put that to one side. This is why I said earlier that this is kind of a basic question; I don't know whether our Commission is going to wander into basic questions of corporate law, etc. But, there is a question raised by the point that you made; it has been raised by some prominent people; and it has been debated. Is the audit committee capable, without a staff, without proper assistance, other than the independent auditors, who may find themselves very uncomfortable, if the audit committee pursues it far enough so you have to point a finger at somebody? Can they do it without the assistance of the independent auditors? And should or will the internal auditors assume that responsibility?

(MS): Manny, if I could address that issue, I would like just to try to give an answer, based on a meeting on audit committees that we had here only about two weeks ago. At that meeting, we had representatives of audit committees, CPA firms, some financial executives and always some academics hanging on to learn. The view there was that a staff was not important. Interestingly enough, this very question came up, and we had some rather experienced audit committee members from large corporations. They felt that the need for a staff to administer
their role was not that important. Instead, they felt that they could rely upon the external CPA and the internal audit staff increasingly to do that job and to highlight these variations, both in terms of internal control, vis a vis the published report, and the kinds of controls under Item II(2) in George's outline—and I restate—not to second guess the management, but rather to see if the system used in evaluating performance internally, is adequate. They felt that they had the resources in hand and that with their experience, which Bob alluded to, they could discharge their responsibility.

(MFC): From personal experience, I can say that I found that generally to be the case. It really depends on the composition of the audit committee and on whether it is really allowed to be more than some kind of a signpost. When an audit committee is composed of persons with experience and some determination, it does a very effective job. But on this question of a staff—and, I didn't mean to make any suggestions—I had an interesting experience in trying to settle a case involving a multi-national corporation. The management was entirely new but the SEC was still thinking of bringing a lawsuit. I think that we dissuaded them from that. But, nevertheless, at some point, I had suggested that it would be a strengthened audit committee if it had a staff, and, by God, we offered to provide the audit committee with an acccountant,
a senior investigative accountant. I thought the SEC staff would grab at that, but they said: "ah, nuts, that is just duplicated in the internal audit. We don't think much of it." We weren't very anxious to do it, and they didn't like it. So, that was the end of that. Of course, that was just a lawyer gambit, I must confess.

(MS): But just let me mention another point that came up in the session, which was very interesting. There was one case mentioned in which they have an annual appropriation of a sum for the audit committee. The committee could use that sum, should the need arise, rather than an ongoing staff, and it occasionally tapped that source when a problem arose that they felt neither the internal auditor nor the external auditor could resolve, and they needed advice. The committee used the funds in that way.

(MFC): There is one aspect of the audit thing, which has gotten to be very popular recently, and unfortunately, I have been involved in more than my fair share of these cases that involve illegal payments, and so on. In those cases, the audit committees have been very, very effective, but in each of those cases, the auditors were there. You really couldn't do the job without the auditors, and they do a special type of examination. Moreover, they do have lawyers especially retained to do this.

(GS): In that regard, I noticed that there seems to be a fundamental conflict between what Ken said and what Bob said;
I may be wrong. I must say that I side with Ken. I think Bob said that the auditor's responsibility ends sort of with the determination of whether the statements fairly present. Well, the statements are really a result. The question is, can the result—I mean—is that enough? Must there be a mechanism, must there be—not a judgment—but a description of the means by which these ends are attained, because although they may work this time, they may not the next time, and so on? In other words, is fairly present satisfied if you describe the results only without some description of the procedures? Ken's example, for instance, about the production line—in other words—does the auditor's responsibility—again, putting aside to whom they report—extend to reporting on, not evaluating, the procedures that exist? I think that is what Ken was saying, and I think Bob takes the opposite point of view.

(RK): I just think that management is in the best position to make those tradeoffs between increased internal controls and decreased auditing.

(GS): No, no, I'm not saying that auditors should decide whether you should have more control or less. But is it important to have a description of the procedures that exist to understand the results of a firm's operations? Do the auditors have some competence in describing those procedures, without saying you should have different procedures, necessarily?
(EH): Could I add a couple of thoughts here? First of all I assume that we recognize when we say,"is the auditor's responsibility thus and so?" I assume that we recognize that what it is now is generally as described by Bob Kaplan and what we are really talking about is whether it should be expanded to include something else.

Now, I have two or three thoughts on the matter of this description of procedures. First of all, is it useful to suggest a bare description of procedures without accompanying that description with an appraisal? The typical appraisal is, I guess, "adequate" or "not inadequate." Query, of what use is a bare description of a set of procedures? Beyond that, I have just one other thought, and that is that when we are talking about procedures, at least to the extent that they run to the generation of financial information, there is a point at which procedures leave off and judgments take over. This point, it seems to me, is very often either ignored or overlooked; it is overlooked in a lot of the discussion about interim financial statements, for example. The reference in the discussion there to the auditor's reviewing the procedures for determining quarterly information—and this would apply to annual information, it would apply to all other kinds of things that come out of the application of procedures—procedures carry you to a certain point, usually at the level of the repetitive recording of information, and, thereafter,
judgments take over. Is the inventory properly valued? Is it saleable? Are the receivables collectible? Are the fixed asset lives reasonably determined? Those kinds of things involve judgment. Somehow or other we need to take into our calculations when we are talking about reporting on procedures, the very significant effect—and much more difficult to appraise and report on—the very significant effect of the judgments that take over where procedures leave off.

(JR): Manny, you were concentrating on Item II(2) in George's outline, and I wonder why. That item has as a premise a certain audit objective, and I would submit that to whom the auditor reports is clearly not independent of what we view audit objectives to be.

(MFC): I agree. I was just trying to arrange that very question in a somewhat different form. If we start with the assumption that George did, that the production of the financial statements is completely irrelevant...

(JR): On that score, I have problems.

Discussion Leader (GB): They are irrelevant in the sense of making investment decisions.

(MFC): Alright, now, apart from the auditor's role as it may affect Items II (1, 2, or 3) in some indirect way, you are really suggesting a role for the auditor totally independent of the financial statements.
Discussion Leader (GB): That is not quite it. Let me bring this back to the efficient market, because that is the rock upon which we are founded or upon which we have floundered; I am not sure which is the correct way to put it. But, in any event, the efficient market is what we are organized around. Let me try to drag that back again. I think that what we learned from the research and the concept with respect to publicly traded securities—again, it it limited to that—is that information about the firm of the ordinary nature described in the financial statements gets to the market rather quickly and is impounded into the stock price in an unbiased manner. That is to say, the market doesn't overstate or understate the price in a systematic way. Now, what that, I think, tells us, as far as auditing is concerned is first, that we have to be concerned with the question: Is there information that otherwise would not come to the market were it not for the auditor? In other words, the auditors, as Bob put it, have a monopoly on this information, and I think that there are things like that such as fraud, mismanagement, gross mismanagement. Then, the question of a cutoff point comes up. There has got to be and there is a cutoff that says, "beyond this point, digging further and further, the auditor has no comparative advantage in the sense that other people can judge the competence of management far better than the auditor," because the auditor is a person with limited ability,
as we all are, but with very strong strengths in some areas and not necessarily in all areas. So, where is this cutoff of the comparative advantages? Then, the second aspect of it is, aside from the comparative advantage, we ought to look in terms of publicly traded companies and say, to what extent does the market already call for this information? Before auditing was required by any governmental agency, it was done, which means that it has meat. That is a very strong indication that it is a valued thing. People normally don't pay for things that they don't wish to continue to have. So, the question is, are we imposing too much? By "we", I mean governments, the SEC, the AICPA, as the—not really a monopoly, unfortunately, not as good as the AMA. And are we imposing costs upon people that are beyond the benefits that they wish to derive from it? That is the question that I was trying to direct the point to.

(JR): Can I address myself to the earlier remarks that George made? I think that Item II of the outline implies a strictly stewardship function of the auditor. You are saying, at least, hypothesizing that the auditor has a comparative advantage of detecting certain information which otherwise would not become available, like mismanagement and fraud. But let's take the stewardship and ask ourselves, why is the auditor reporting on stewardship? There are two possible interpretations. We will go back, if I may, a little.
Independent auditors could not benefit from the objective of informing the stockholders—the public, if you wish—on certain things. I think this is really what becomes crucial and this is what we ought to look for. I mean those things which a firm's management left alone without audit would not have a set incentive to report upon or to produce the information. Now, I think, I quite agree with you that fraud is such a case; clearly, the management committing fraud would not have an incentive to report on it. Mismanagement is also such a case, although here there are cost-benefit issues of whether the auditor can be effective in detecting mismanagement. But why not just expand this concept of usefulness to the public or to the investor? We could say: "let's explore those types of information that in the existing market system management is not likely to have any incentive to generate and to disseminate." Then, why not posit as an audit objective to concentrate on this information? If the auditor cannot be effective in doing that simply because of his lack of qualifications, let us address that issue separately. But it seems to me that fraud and mismanagement is clearly not the only thing. This comes back to your initial discussion, that is your premise, which I cannot agree with
completely, that financial statements have no usefulness as signals to the market for resource allocation. I don't think we have any conclusive evidence that it is not. We do have some evidence that it is; we have some evidence that earnings numbers affect stock prices. It has been consistently found that we have evidence. Once one buys this, he must agree that it does perform a useful purpose in signalling the market. I clearly agree that usefulness is much greater for organizations for which there is no market, like government, and so on. But if it does serve that useful purpose, then we should explore into the other kinds of information that managements would otherwise not make available voluntarily. Another side of stewardship, by the way, is deterring management fraud simply because management knows that it will be audited. But—that—it is not clear to me that it is really the responsibility of the independent auditor or the audit committee and what the cost-benefit relationships are. It may well be the audit committee without the independent auditor can do it more effectively and more cheaply.

(MSh): I would like to make explicit what a lot of people have been saying collectively, perhaps implicitly, by inference from their specific remarks. Perhaps it is useful to look at the overall process in the economy. We are really concerned with the efficient allocation of resources, and we
really have a system design problem. How do we specialize various functions within the economy so as to make efficient utilization of resources? So, historically, we have various actors or participants, who have played different roles, and in themselves have particular interests. When we talk about what the auditor should or should not do, what the auditor's role is or is not perhaps we would do a little better if we stand back and say—or if we disagree with this point of view, then somebody else might advance another one—that a reasonable point of view is that we are all here today because we are ultimately concerned with efficient utilization of resources in the economy. Then we are faced with a question of what constitutes a good design for an economy, a system design for an economy? Naturally, any system is a specialization of functions because no one function has the expertise to process all of the disturbances that are going to happen to the system. So, we specialize roles, presumably to expertise. The auditor has a certain expertise; he can deal with certain functions. Eventually we have to relate, I think, all of the functions to a cost-benefit framework. That is the only way of assessing whether in fact, the system is an effective way of bringing about the desired results. But I guess what strikes me as we are talking is that in order to answer and to perhaps focus on the debate, we really have to stand back and say: "okay, person A makes a point. How does this relate to the
overall goal, which is to deal with efficient allocation of resources? Is a specialization of this function better handled by the auditor than by somebody else?" Then, we look at any one participant, say the auditor. We find out that he has really multiple roles. He acts as a consultant. The question is: Is he a better consultant than somebody else? With respect to a lot of information, there is enough incentive on the part of management to internally generate it. In other words, for their own interest, they would like to get certain information and be darn good at it. On the other hand, there are other kinds of information which they are not that interested in getting out. But somebody else is interested; maybe the auditor has to get that. Still, with respect to the first type, maybe the auditor has particular expertise. An auditor has many clients; he has a different concept of business, more insights, a broader background than an internal auditor on the staff. We may want to bring him in for that reason. So, naturally there is going to be confusion because we are groping with the historical role at the same time we are trying to I think ultimately work towards an efficient system design for dealing with the allocation of resources in the economy. We should focus on that in terms of our statements. What is the best way to design the various functions to do that? I think maybe in that way we can get a little more of a convergence than we have had so far.
(MFC): First of all, I should say, for myself anyway, that my own objectives are somewhat short of the grand objective that you have described here, but we do have a problem of describing the role of the auditor in society, which brings us right into this. I hope that we can ultimately address that in some sensible way. I do want to raise one question here. It was suggested—although there is no unanimity of opinion around the table—it was suggested that the auditor really doesn't have the ability to deal with (b), (c), and (d) of Item II(2) of the outline whether or not those are appropriate objectives. Yet, on the other hand, the very same auditor—and I use the firm rather than the individual auditor—advertises and sells something called MAS, which presumably involves (a), (b), (c), and (d) of Item II(2) in some fashion. Now, is there a basic inconsistency in what I just said or in what other people are saying in this area?

(RE): May I address that particular point? The question of qualifications of auditors has come up quite a number of times in terms of comparative advantages of auditors to do some of these things that are under discussion. I think it would be wrong to conclude that because today's cast of characters in the auditing profession can't do these things that your Commission needs to ignore them, because the fact is that, if they need to be done and other people have a comparative advantage, we could, over a 10 or 20-year time frame, change the personnel characteristics and description of
auditors. I don't think that is a constraint over the long run that we ought to allow to govern these discussions to such a great extent.

(MFC): I wasn't suggesting that we are constrained.

(LL): Manny, you said it yourself. The auditing firms have these skills, but they apply them to special engagements rather than enhance the auditing functions.

(MFC): I'm not talking about the way the profession accepts engagements and how it arranges for its compensations or anything like that. Those are separate issues irrelevant here today. I was really raising the question for some discussion here of whether there is validity to the statement that the auditor—that professional auditor out there—really doesn't have the capacity today or, as has just been suggested, that even if he doesn't have it as fully as he should to meet these objectives—assuming they are valid ones—should he acquire them? Those are the issues as I see them.

(RK): There is a question of to whom these different types of reports should go, and maybe that is what we should discuss. It is not clear to me that questions like (b), (c), and (d) of Item II(2) of the outline are appropriate things to be discussed with three hundred thousand stockholders.

(MFC): Why not?

(LL): In most cases, it would do damage.

(MFC): Bob, I accept that, and I merely said earlier that I thought...
(RK): As a stockholder, I buy securities, forty securities in a diversified portfolio. So, you would really overwhelm me with an amount of information that I could not tackle. I would rather delegate that responsibility to my outside directors and say to them: "Look, you are running this company and maybe two or three others, and you better do a darn good job of it."

(KJ): I think your answer—what you are really saying is—that you don't have the capacity, and you brought in a new term that we haven't used this morning, outside directors, which is the real benefit of the audit committee. If I were going to do it, I would just strike audit committee, and say that what we are really talking about is talking to people who represent the stockholders and are independent from existing management. What you are saying is that you, individually, don't have the capacity to digest and take action on all of the recommendations that may come out of this process. But in a larger sense what you are bringing out, I think, is that there ought to be some device in our system that allows for a type of specialization in terms of outside directorships that really would be interested in comments of that type and in fact may insist that we provide them with those types of comments.

(RK): I think that that is exactly what I was getting at.
(KJ): Well, that is a response, isn't it? It is the individual stockholder's response. If the individual stockholder says: "Look at it this way, if you give me a recommendation that says, 'internal control is not good, there isn't much that I can do about it."

(RK): Suppose he holds only 27 shares.

(KJ): But he may decide: "Gosh, I need a good outside director on the Board of the company." If he has 27 votes to start with, you see, it is just uphill, but he can do it."

(MFC): I think that that is right, and I was going to say, Bob, that I understood your statement of why you questioned the efficacy of giving this information to the shareholders at large, even if they are all made up of great management experts. One shareholder really couldn't do much about it. But it seems to me that the assumption, the premise, underlying the statement was that it should be reported to the shareholders' representatives. I just want to know whether that is a fair assumption to draw from what you said?

(RK): Well, as to the questions in (b), (c), and (d), I think the shareholders, some shareholders' representatives should have access, should be able to demand, that kind of information, whether they want to use the internal auditor or the external auditors.

(MFC): When we talk about this internal auditor thing... I am sorry.
(DRC): Let us give Pete a chance.

(RD): I'm back to the point that Bob made a long time ago about the extent that financial statements present fairly the information. The auditor may be aware of ineffective management controls, and I think that means that he does a different kind of audit. He does more work to insure that in fact financial statements present fairly. I guess as an investor, I'm relying on him, or, in effect, the investment community to do that. I think that what I see, ex post, the data I see coming out of the financial statements, do in fact reflect some judgment on the part of the auditor to insure that the statements present fairly.

(MFC): Please don't misunderstand me. I'm deliberately trying to create a real conflict here. But let's take what you just said. What you said is that financial statements, assuming you don't go beyond what you consider to be the traditional role, reflect what has happened. Many people think that, for whatever purpose, whether it is market evaluation, or otherwise the financial statements are supposed to be predictive. The SEC is picking up some such silly notions. Now, if you merely reflect the past, and you don't have some information with respect to the points here, however that is described, then those financial statements may not
fairly predict the future. I don't know whether that is a concern to anybody.

(GS): Should you only concentrate on the output or the process or should you concentrate on the process as well as the results?

(JR): It comes back to the concentration on stewardship.

(EH): It seems to me that here is a place where your Commission, Mr. Chairman, can make a very substantial contribution... (MFC: That is what I'm afraid of.) ...among other places, and that place is to find a way to communicate to people the extent to which it can reasonably be expected that financial statements are predictive and the extent to which it cannot be expected. (MFC: I accept the suggestion.) Now I have been troubled, as perhaps your comments indicate that you have been, by the SEC's blithe comments about predictability.

(MFC): Well, I didn't mean to express a view. (EH: I'm disappointed.) I merely intended to bring to everyone's attention again that we are living in a real world. But it is a moving world, and the rules seem to change all the time. And yet, all that raises some basic question as to the role—those are hackneyed words already—but the role and the responsibilities and, as someone suggested, possible consequent liability.
(EH): That is the first time that word has been used this morning, but I'm glad to hear it come into focus.

Discussion Leader (GB): It is the real world, again, in the sense of the efficient market. I am trying to keep it directed towards what we are organized for.

(MFC): Or even if some of you around here can persuade us that the market's pretty inefficient.

Discussion Leader (GB): The interesting thing about the research is that that is the real world. There have been many conferences in which people who deal with trees are of the assumption that they are looking at the forest, and they think that they are looking at the real world. The advantage of this research is that in fact it has given us a look at the real world, not just a piece of it, but a larger part of it, so we could make generalizations. Therefore, I suggest that we consider these questions within the scope of evidence. What evidence do we have, for example, with respect to the questions Josh raised about the possibility that management may not have an incentive to disclose information and the possibility that people don't know about it? That is to say that the market doesn't react as if it did know about it. The fact that it hasn't been disclosed by one person doesn't mean it is not known by some. The second thing is, what evidence do we have that in fact auditors have done a bad job? Are we trying to correct a situation that doesn't
exist? The fact that you have got a few cases doesn't mean that the world is bad. Or the fact that you have a few cases doesn't mean that it is worth trying to correct it.

(JR): Unfortunately, it is empirically very difficult to find out whether information for which there is no incentive for management to produce was obtained from alternative sources or not.

(RK): There is a study, the Collin's study on circumstantial evidence, that suggested that (a) information within the firm that was relevant to price-setting behavior gave better predictive behavior about the stock prices and (b) was not disclosed.

(JR): And (c) that it was extremely weak.

(DRC): We are going to have to break for lunch. Chuck, you indicated a desire to comment.

(CW): I really wanted to come back to the point that Ernie made about 15 minutes ago, which I suspect in listening to the conversation around the table kind of got missed. His point was that putting out a descriptor about procedures takes you only just so far. There is going to be some point reached where we put information on these financial statements that is so irrelevant that it won't have any effect. Academicians will be able to study that 20 years from now and prove that it didn't have an effect. For example, we might get information such as the eye color of the top executives of the company, which I think is probably about as relevant, George, to
decision-making in the stock market, as whether Susie Q and Mary X in the cash disbursement function are separated one from the other, which I take it from hearing your remarks is part of the kind of thing you would have us put in, descriptors, not evaluators. I don't think anybody is going to be able to do a thing with that kind of information. Five, ten years from now we will be able to prove that.

(JR): The point is that financial statements do have an effect.

(DRC): Well, Bob.

(RH): I would just like to make a comment in connection with Joshua's and his neighbor's comment earlier and Mr. Cohen's response. It seems to me that you are saying that these ideas about looking at the resource allocation process are too grand.

(MFC): I didn't mean to suggest that.

(RH): Okay, then let me say that I think you do need to very carefully consider the effects of your Commission's work on the social institution and on the way the incentives are placed.

(MFC): Let me assure you that we are certainly paying what I hope will be a reasonable amount of attention to that problem. I want to emphasize that I am trying to stir up some real controversy, and I think I have. I would like to continue it.

(RH): The reason I raised that was not to say that what
you had said was wrong. I feel that the reason we are having trouble when we bring up the issue of whom we are reporting to, the stockholders or the audit committee, is that we haven't really addressed the basic question of what will be taken care of through the private enterprise system by incentives to produce information and what is going to be taken care of through the more public kind of system which is enforced upon the auditors through the courts. In that context, I think that this difference in having confidence in management advisory services but then asking if we should judge effectiveness shows that the private system has worked pretty well.

(MFC): I understand what you are saying, and I accept it. I hope you won't think that I'm irreverent if I say to you that I started out as an economist and that someone wiser than I directed me to law school.

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LUNCHEON BREAK
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Chairman (DRC): We still have some questions to pursue. I did want to pursue the last two items in George's outline, but before we get to those, we should probably consider the subject of fraud detection, which, as Bob Kaplan was observing, hasn't been discussed too much. We could assume from that that everyone has accepted it and felt that there was no need for discussion.
(RK): I at least wanted to raise this issue when George was saying it was obviously a function of the auditor to try to show when the managers are in effect using the resources of the company for their own personal gain, for example, the embezzlement of cash. I, at least, just wanted to say that the issues can easily get a lot less clear than that, because you have the question of company purchase of membership in social clubs, the use of chauffeured limousines, and company airplanes, and many other perquisites of office. At what point does the auditor decide that that kind of thing is an excessive compensation to the managers, improper use of company resources by the management and therefore on the borderline of perhaps fraud and not carrying out the stewardship function of management? When it is out-and-out stealing, actually taking the cash home and falsifying the records, then maybe the issue is more clearcut. So, how much are we willing to spend to find that at a basically immaterial level? That is the question we should address. Once you commit yourself to a policy of looking at things like that, it seems that you get into the determination of executive compensation with all of its perquisites.

(WN): Well, in the one case there is some kind of disclosure required, but in the other case, i.e. fraud, every effort is made to conceal it. I think that that becomes a fairly sharp distinction in what you are looking for. In the
first case, maybe the purposes per se don't get disclosed, but management contracts that provide a lot of extra benefits have to be disclosed today in the proxy statements. The stockholders can make a judgment on it if they choose to do so. I don't think the auditor has to make a judgment on it. But in fraud there is a real effort to conceal that.

(DS): Disclosure isn't the end of the story. What is the position of the auditor in the recent Lockheed situation where officers of the company who were virtually dismissed from office for dereliction of duty received ten-year consultancy contracts for $70,000 a year? That information has been disclosed; it is not a secret. Is the auditor responsible for seeing that the company get value for its money? I just asked that as a question; I don't know the answer.

(KJ): Let's get away from the Lockheed situation, which is sort of a hypothetical question.

(DS): That isn't hypothetical.

(KJ): Oh, I think it is.

(CW): He wants to address it as hypothetical.

(DS): That's too difficult for me.

(WN): Let's take Lockheed for a minute; I think that it is interesting. The question now is, do they do anything of value for the company in return for the $75,000 a year?
(CW): Yes, they get the hell out of there; that is what they do that is of value.

(RK): That's called "exit value."

(LL): Are you suggesting that the auditor should be not only a policeman but also a judge? I don't see how he can do that.

(DS): I don't see how either. But it seems to me that there is a need for the stockholders to be informed as to whether the payment of $70,000 is for something or nothing.

(LL): That must have been the disclosure you talked about.

(EH): Don't they know that?

(DS): The disclosure was that they were getting $70,000 a year for ten years as consultants. It doesn't say anything about what they do.

(CW): But nothing will happen anyway, will it? It is reported in the latest filings of Rapid American, to pick another one, that the Chairman of the Board, Ricklis, took a $555,000 fee for the disposition of Playtex, a corporation which they just happened to have owned. Now, is that fee fair? Should he have receive it? Suppose I were the auditor for that company, how would I judge that? In what contexts? Against what norms? I guess I could study Marcus Aurelius, Plato (voice: Winston Churchill)—But what?

(DS): Why are these all Western writers that you are studying?
(EH): Omar Khayyam?

(JR): Omar Khayyam? Well, that is an existentialist; that is alright.

(WN): Let's take Lockheed. Now, they may have a consulting contract that may be specified so that the auditor can verify that they performed according to the contract, whatever that might be. Or let's say that they were required—or did—in fact show up at the office a certain number of days a year or to submit proposals on one thing or another or to attend conferences. If they didn't do any of those things and they were supposed to, you might say that the company wasn't getting enough value. But let's say that they did do those things, on a sort of a pro forma basis, then the auditor has a difficult job to evaluate whether or not that kind of time resulted in any real value to the company. I don't think the auditors can do that. He can determine whether certain motions were gone through to have a nominal compliance, but he can't make a judgment as to whether their input was worthwhile or not, really.

(RK): I hate to keep coming back to this, but isn't that a function of the board of directors to determine whether they are getting value for what they receive and not the role of the auditor?

(KJ): But the Board may never see the contract.
(EH): Who doesn't see the contract?
(KJ): The board of directors.
(RK): They should. Who is giving them the contract?
(EH): They could if they wanted to.
(JR): But what about outside directors and the audit committee?
(WN): Well—the auditors—the Board would certainly know about those contracts.
(KJ): Oh, they would know about it, but I wonder—just in a hypothetical way—I wonder, how many business contracts the board of directors gets into in the ordinary case? They don't see that many; I don't think that they do.
(CW): No, in that case, there is a pattern; I agree with that. But in this particular kind of contract, they would surely know what the contract called for.
(KJ): I would think so.
(JR): It is a question of delegation of authority and of who should see these contracts and report to the board of directors.
(WN): But in the whole vast activity of Lockheed, no, I would agree that they wouldn't see a lot of contracts.
(RK): Let's look at this on a broader basis; let's forget about Lockheed for a moment. You don't ask the auditor to make judgments about whether or not the firm gets value for its money.
(WN): We haven't in the past. Our question is: Is that a future responsibility of the auditor?

(RE): We do in this sense; at least the auditor is responsible for finding if the current value of assets is less than the carrying value. In the case of buying inventory, the company doesn't get value for its money, in theory at least, if the inventory has to be written down to what its value is. So, the auditor has to have responsibility with respect to a wide variety of assets, at least.

(RK): Human capital is always carried at zero. So, that is not a particular problem.

(GS): It seems to me that this is not an auditing problem we are addressing. The real question is, when you enter in description of "consulting services" when this is really a deferred compensation plan, that is, what is the proper accounting for it way back? No one really believes that a guy gets $150,000 or $75,000 for services after he stops being president. This is merely a deferred compensation plan. The question is, what is the proper accounting originally for plans of this sort? That goes way back; it is an accounting problem.

(CW): That problem has been resolved, George. It is in the literature.

(GS): Isn't it really a fiction that he is getting $75,000 for "consulting services" that he presently provides?
(DS): The question is whether disclosing it as consulting services is in fact disclosure at all.

(GS): I agree, but that goes way back. Originally, when he signed the contract, you build those things in. What is the proper accounting for this essentially deferred compensation?

(WN): How could you provide retroactively in the Lockheed case?

(GS): Well, I'm not saying you should. I'm saying that the original problem is when they entered into the employment contract. The question is, how should those deferred compensation situations be accounted for?

(CW): If the rule of the APB Opinion applied, it would have been accrued over the term of employment to retirement.

(WN): It is just that the term of employment got rather summarily terminated.

(MS): The original contract in Lockheed didn't call for his dismissal many years before retirement, I think. So, we have a unique case, and therefore the normal kind of retirement pay wasn't implicit. This is a unique situation, which David is offering, rather than the typical one, where you have built into the original employment contract some notion of retirement on some basis with some supposed activity.

(RK): What you are suggesting is that the payments are a cost of this period. You take ten years at $70,000 per year
and reduce the payments to current value, and that is a
cost of the current period.

(MS): Well, David's question was not accounting for it.
David's question was one of injecting a qualitative judgment,
if I read him correctly, and I think we have to separate the
pure accounting for this on the assumption that it was for ser-
vice given versus before you record it, were there any services?
I think that there is a difference here, and I think we should
separate them.

(EH): Are we talking here about something that is petty?
(CW): Yes.

(JR): Are you making a distinction between production
decisions as it reflects the operation of the firm, and infor-
mation production decisions, where the auditor might get
involved? Or should the auditor really involve himself with
judgment on operating decisions, such as, "are you getting
your money's or worth value?" Or is he restricted or, rather,
do you view his objective as restricted to information on
information? That is, how reliable is the information, how reliable
is disclosure, regardless of whether that disclosure reflects
bad or good decisions, operating decisions?

(WN): Isn't our distinction here between the ordinary
operating decision and a contract concerning the top officers
of the company, where they may have conflicts of interests,
present and potential?
(RK): Well, isn't that an operating decision? We are hiring a manager to produce services.

(WN): Yes, but decisions down the line are presumably made on an objective basis, whereas when we are involved with top management itself, you have conflicts of interests, self-serving decisions, that kind of thing. Therefore, it is of particular interest to the shareholders.

(RK): But that is exactly the role that the outside board members play.

(JR): Why not the board of directors and the audit committee?

(RK): One of the most important things is that the compensation of top management of the corporation is a Board discretionary item.

(EH): You were saying conflict of interest, conflict between whom and whom?

(WN): Why is it then for years that that has been required to be disclosed to shareholders if it is entirely a Board decision?

(RK): They are reporting to the shareholders the results of their decision.

(LL): If it is a board decision, is your point that it should be a board decision? My guess is that in the typical case of this untypical happening it is. Oh, I have seen it
happen a number of times, not just with illegal payment. It is where, for some reason, the chief executive officer gets himself fired by his board and his board, feeling a little bit sorry for the action they take, gives him something that probably, under the circumstance, he would not be entitled to. But in their judgment, this is the best thing for the company, to fire him, get rid of him, and give him something which you may decide he shouldn't get. Now, if the board decides it, are you raising the question of what is the auditor to do?

(RK): I'm saying it is not the auditor's role; it is the Board's problem.

(JR): It is the auditor's role though to disclose whatever information he thinks is useful. This is really what the issue is.

(KJ): The auditor is supposed to comment on the accuracy of the disclosures that are made by management.

(WN): Disclosures aren't made by the auditor anyway. They are made in proxy statements. The Lockheed disclosure was made in the proxy statement. The auditor doesn't audit that.

(CW): But we have another information responsibility if we are associated with it. (WN: You do.) Yes, according to the SAS, we have to read it, yes. (WN: Is this for proxy type information?) You bet. We have got to read it, make sure it is there aren't material misstatements, and make sure that consistent with the full financial statements.
(WN): What would you do in this Lockheed case? Would you go and examine the contract, for example?

(CW): I don't know about that one. I probably wouldn't have; it is probably not all that material.

(WN): Well, if you are verifying the proxy statement...

(RK): Nothing in the officers' compensation is going to be material for a five-billion dollar corporation. Right?

(CW): Yes, but it probably got my name on the tax return, which has a schedule.

(WN): It was surely material in the Rapid American case, wasn't it?

(MFC): I came in here a little late, and I'm sorry about that. If you assume that SEC's proxy rule requirements are based on its notion of material information to be provided to investors, isn't it material in the context of financial statements?

(LL): No, not necessarily.

(KJ): But that is an accounting question, I think, though.

(JR): But you can't really quite separate the accounting question from the auditing question. It is really quite difficult.

(CW): Do you mean—is it a suggestion—that everything that an investor needs to know is material for a fair presentation of financial statements?

(MFC): I didn't say that, I was merely asking a question.
With respect to the top management, and the rules are limited to top management because of the position that they have and because of potential conflicts, it is the rule—whether it is a proper rule or not we can put that aside for a moment—it is the rule that you have got to disclose compensation... (EH: In the proxy statement?) in the proxy statement, okay, and there is an obligation on the part of the auditor to review the proxy statement if it is accompanied by financial statements. Is that right Chuck?

(CW): To read it for material misstatements and inconsistencies with the financial statements which we audit. Those two things

(LL): But our review is not from the idea of value given.

(MFC): Now, let me ask a more fundamental question which you may have already resolved. Did I understand that there was some question about whether the engagement letter is something that is reviewed by the Board? Ken, did you say that it is not?

(KJ): No, what I said was that there are a lot of contracts that are executed by management that never reach the level of attention of the Board. It seems to me that is is a matter of some sort of system that produces unusual transactions for the Board's review.

(MFC): Let me push along here. Should the engagement letter be reviewed by the Board?
(KJ): Which engagement letter, is this the auditor's engagement letter?

(MFC): Yes, the auditor's engagement letter, so the Board knows what is expected of the auditor, and what the auditor contracts to do, and doesn't do.

(KJ): I don't know but I certainly think it's a good thing to be reviewed by the audit committee.

(MFC): But the audit committee is really a committee of the Board. So, you are saying yes.

(EH): I think the point is that it is not a bad idea. The next question is whether somebody would want to mandate it, because this runs to the very question of the right of people to contract with people, and under what constraints.

(MFC): I agree with that. I think you are right on target and that is the reason for my question. But the Board is a representative of the shareholders and as a representative of the shareholders contracts with the auditor, the only independent person in the whole picture. Then, is it of some consequence, at least, to compel that representative to know what he is getting and to have some decision with respect to what he is to get? If he is not in at that level, how could he complain later that I didn't get what I needed from it?

(DRC): Most of the important things that are expected in an audit are implicit and not explicit in the engagement letter.
Most of the important responsibilities are implicit responsibilities that are not stated.

(GS): Well, I think maybe that should be made explicit.

(JR): Should it be made explicit?

(MFC): I'm just raising the question here.

(EH): But, if I could continue, it is not a bad idea, and I would see no reason to object to it. The typical engagement letter today would say that we contract to report on the financial statements, their presentation in accordance with generally accepted accounting principles. We will consult with you on accounting problems if you ask us to. We will do whatever it is that we agree that we shall do with respect to interim financial statements under ASR 177. And we will do certain tax work for you, or we won't, depending on how it works out. And we will do management services consulting, if you ask us to, and upon particular further agreement. And that is what the typical engagement letter today would say.

(CW): It typically adds a sentence. Most of the firms, I think, are adding sentences discussing the illegal acts area and errors and irregularities, indicating the degree of responsibility that they feel the average audit can cover.

(MFC): That gets very close to the reason for my question. Would it be a healthy thing if the audit letters were reviewed by the audit committee?

(EH): Would you say that again?
(MFC): Would it be a healthy development if there were a rule which requires that the engagement letter be approved by the Board, or by its committees?

(EH): Probably.

(JR): Any information reduces uncertainty, I cannot see anyone really rationally objecting to that.

(RK): No, that's not important, Josh. It seems like a fundamental responsibility that the audit committee should know what is going on in the audit.

(JR): I think that that is precisely right.

(CW): You are not going to learn anything from reading an engagement letter.

(RK): Well, maybe we should get better engagement letters.

(WN): Does the engagement letter tell how many subsidiaries that you are going to audit?

(CW): No, it doesn't tell the extent of testing. As a matter of fact, it would be dangerous from an auditing standpoint to spell out our procedures, because it would give management warning as to how to work around our letter.

(RK): No, that is nonsense.

(WN): That, nevertheless, is the question I'm raising here. Let's say he is interested in getting a budget on the audit so he can determine if the cost corresponds with the budget.

(JR): You seem to be saying that the information provided in the engagement shouldn't be disaggregated to the extent that
would be counter-productive in that management gets a clue as to what precisely to avoid.

(CW): I think that is part of it. But I also think that all ought to look at a typical engagement letter, and I think that you would conclude with me that it is fine for the board to look at it. First of all, when the audit expenditure might be considered immaterial to the Board, it might not be to the audit committee. Secondly, they are not really going to learn very much from it.

(MFC): That doesn't answer the question. Maybe they have an obligation to learn a lot about it.

(KJ): Manny, are you asking the question of who engages the auditor? I'm just trying to identify the cause of your concern.

(MFC): That question is involved in it, Ken. I wasn't limiting the question, but I assume that that would come up in the discussion.

CHAIRMAN (DRC): It seems we are dealing with form rather than substance. Perhaps we should get back to the substance. The real question that we seem to be looking for, when we started the discussion, was not so much whether the auditor should or shouldn't be responsible for something, but how do we decide? And what is it that distinguishes the fact that management is getting a certain amount of compensation called consulting fees that might not really be consulting fees or the company is not getting value for
the money? What distinguishes that from stealing? We all seem to agree that stealing is something the auditor should be concerned with call attention to. The real question is, what is the dividing line, how do you make the dividing line more than what falls on which side of the line?

(GS): In that regard, in our meeting two weeks ago on materiality—not materiality, although it is related—on the audit committee, one of the things, Manny, that we were talking about there was, should—the audit committee presumably hires the auditors—should there be some discussion or some agreement as to the level of—I hate to say materiality—but the level of accuracy, precision, and so on, that will be exercised in the audit process? Obviously, there is a cost-benefit situation there, right. Who is to determine, within broad professional guidelines, how narrowly or how precisely the audit process is to go? What is the desired cost-benefit relationship? Should that be something that the audit committee, Manny, be knowledgeable about? What is the desired level of precision, what is the cost, and so on? And how do you get some communication about that?

(EH): George, it seems to me that you are raising a question that ought to be answered by the Financial Accounting Standards Board. That group has—well, you shrug your shoulders and sigh—but nevertheless that group has before it a project on materiality. What you have raised is really the very question of that project of theirs. It would seem to me that a particular
audit committee of a particular board of directors would not want to have, once the FASB issues a statement, a different level of precision in its statements. Would not want to have—would not want to work towards—a different level of precision than that level which is generally understood to be the acceptable level for all companies.

(GS): That is not clear, Mr. Hicks. It seems to me that maybe if the FASB works, that this will have a floor. An audit committee may desire a higher level or lower—you could always argue which it is. I'm not sure, by the way, what the appropriate adjective is. In other words, that it may want to have a greater confidence than the minimum confidence that is required by the materiality standards which are imposed by the FASB. It is conceivable and I'm saying that at least this came out from our discussion.

(MFC): Let me put it in the context of a particular situation. In one of the very early cases involving foreign payments after we had marched the individuals into the special prosecutor's office, and they had taken their pleas, it was my feeling that the SEC ought to be put in possession of the relevant facts as promptly as possible. So the pleas were taken in the morning, and in the afternoon we were in Stanley Sporkin's office. We indicated that the company intended to make an appropriate investigation, and how it was to be done, and so on. This was almost by way of a model of what happened later. But one of the questions put to me was: Who were the auditors that are
going to be involved? You can't do this yourself. I said "well, the regular independent auditors." The answer was: "My God, they missed the boat!"

(EH): By whose definition did they miss what boat?

(MFC): That is part of the real world. What I'm saying is this: a lot of things have happened since this explosion of Watergate and the consequent investigations, and so on, and I think whether this is accepted because everybody thinks it is appropriate or whether it is accepted for other reasons, audit committees have become very sensitive to this issue. It seems to me that if that is a fact, that is a true fact, then the audit committee ought to be the body that decides what the independent auditors should produce for their benefit.

(EH): That is a matter of contract. I have no problem with that.

(LL): Manny, to me you have twisted this a little bit. We seem to be talking about the responsibility of the audit committee rather than the responsibility of the auditor, and maybe we should get into it. If you want to talk about responsibility of the audit committee, talk about something important, not audit our audit program. I don't think they really select the auditors; I think they carry out management's wishes. I don't think the stockholders select the auditors. And if you really want to get into something sensitive, if that audit committee, independent
of management, could say who the auditors were going to be, maybe you have made a first step at arriving at something.

(MS): I would like just to inject something on this one point. The view at the meeting two weeks ago was that while historically the situation was as you described it, the movement was in a direction that they would stand on their hind legs and say "we, the audit committee designate the auditor—no matter what you, the rest think—we will press and stand up on our legs and insist." So I think it is an evolving kind of change.

(LL): I think that would be good.

(MFC): Lee just said, that is good. It would seem to me that would afford a measure of protection to the independent auditor that he does not have now.

(MS): Yes, it is two ways. Can I just offer one question here? Now, just on this point, there are two issues here, and I think they should be separated. The first is the formal engagement letter, and the second is the subsequent discussion of specifics. Now, would it be fair to say that the engagement letter, as I heard, is a rather short document with no extensive exposition on where and how you go about the job? Therefore, its utility to an audit committee would be nominal, and it would be fair to suggest, that before very long we have a standard engagement letter which is uniform in the profession. But the real key is the level of exchange between the auditor and the audit committee, once
the engagement letter is in and the specifics are spelled out by this exchange. Because in discharging their role as audit committee members, they are vitally concerned with the depth to which one goes, the extent of the audit, so that they can respond and worry about the internal audit system and get involved. So, you really have two levels, which suggests that a requirement that this engagement letter be reviewed by the Board is no great requirement because it doesn't say anything in the first instance.

(JR): But it can be specific as to responsibilities but not necessarily as to procedures.

(MS): Well, it is just like the standard certificate. Okay, we have it, now let's forget that and get down to essentials.

(CW): Can I speak? I can't be very specific as to responsibilities, because I want to tell you that I am not going to commit, in advance, the responsibility I'm going to take in my audit report letter on those financial statements, until I've done an audit and then I will tell them. Believe me, I'm not prepared to take any responsibility before that.

(MFC): Let me rephrase this, Chuck, in a way that I would like even better. You are a professional, and therefore you can't be bound by any such arrangement to the extent to which you act as a professional. That I understand and I accept in you. But I think that is not the point.

(KJ): Let me just go on here. First, we are talking
about a separate standard or measure of morality executed by
the auditor along the lines of the Lockheed case. The second
thing, Manny, is that you are bringing out that the audit
committee ought to have the responsibility in fact to engage the
auditor instead of endorsing management's pre-selection.

(MFC): It is a fairly simple proposition I'm proposing.

(KJ): On the question of what the auditor does with
the contract, my guess is—I don't know anything about the
company that we are talking about—is that the contract says that
Mr. X will hold himself available for consultation and it is the
act of making himself available, agreeing to consult if asked,
that he is being paid for. What we are struggling with is, how do
we distinguish one act which is going to be criticized, that is
stealing, from another act which is going to get some sort of
acceptance by the stockholders, such as these consulting arrange-
ments? I think the point of distinction is that the auditor
should perceive the cutoff point from the standpoint of the
shareholder, since that is the person to whom we are reporting
indirectly. The shareholder will take objection to some action
by management, and clearly in this case, because there was
disclosure, and the stockholders did not react, that must be
acceptable to them as a means of either providing some sort of
deferred benefit or some other recompense to the people that
have been discharged. And that is really what our cutoff point
is in these sorts of cases.

(CW): Except, you know that that is not true, either. You
know that proxy solicitation results in an automatic vote for management's actions. You know that people don't think these things through, and you know that these things are automatically ratified and, indeed, that the democratic challenging process really doesn't work.

(RK): But you want the auditors in a position of challenging that system and saying, "stockholders you are doing a dumb thing."

(CW): I'm not the one suggesting that we make all these normative judgments.

(LL): There is a point at which your head, your judgment and your stomach being weak can't take it anymore, and you might just step in and do something. I have seen it.

(DRC): The purpose, at least, the conventional wisdom on proxy disclosure of things like compensation is the moderating influence. It is not based on the presumption that shareholders will scrutinize that data and pass on it, as agreeing with it or not. But the mechanism of disclosing it will itself exert a moderating influence. If that doesn't work and if it gets really out of bounds, then people will really stand up and scream.

(GS): Let me ask a question that has always bothered me about this requirement. You require disclosure of compensation in situations where there are potential conflicts of interest. Is that right?

(MFC): It doesn't go quite that far but it moves in that direction.

(GS): Okay, what is the auditor's responsibility, if any, when compensation takes a form, so that it cannot be quantified
namely, stock options, deferred compensation, and so on, where there really is no way to quantify that kind of thing?

(EH): Options have to be reported in the proxy statement in the same section as officers' compensation.

(RH): That is not the thing that is difficult. It is the use of company aircraft, the use of company suites at the Regency, all these kinds of resources that is the stuff that is hard to quantify. Stock options are simple.

(JR): Stock options can't be quantified, but limousines can be disclosed as a fact without quantifying the price.

(GS): How do we presently quantify stock options, I mean the compensation involved in terms of them?

Chairman (DRC): Can we throw out the accounting question and move on.

(RK): It is 10,000 shares at this list price and you use whatever option pricing model you want to use to determine the value of that.

Chairman (DRC): Before we leave George's outline, I would like to try to touch on his last two questions. Could you read us those, George?

Discussion Leader (GB): Yes, the third one is: What is the rationale that supports or rejects requirements imposed on private corporation that govern the extent of audits? The first question under that is: Would the optimal amount of
auditing be achieved without requirements being imposed by governmental or private authority? The second is: If not, what are the relevant externalities and utility maldistributions. Let me just explain the last part, because I put it in somewhat technical terms or at least in my jargon. I just have to say that normally there are only three reasons why government should intervene in private affairs, other than the fact that they rather enjoy the exercise or that is the individuals involved in personally accomplishing it enjoy it.

(MFC): I think that is biased.

Discussion Leader (GS): I think that is not biased; it is a statement of fact.

(MFC): I think that that is the end of the argument.

Discussion Leader (GB): I think that to some people—power is obviously something that interests a lot of people, and they usually go into positions where they can exercise power. They become tenured professors or a variety of other things.

(JR): As Kissinger said, it is the best aphrodisiac.

Discussion Leader (GB): Yes, alright, in any event, that is another confession. By externalities—I said three reasons—one is an externality, neighborhood—something that Josh has mentioned a variety of times, and others have—namely a corporation may not provide information to the shareholders because it doesn't benefit those groups of shareholders that cannot garner the total benefits of the information but others benefit from it. So, they have an interest in seeing that it is
produced. Society as a whole may have an interest in seeing to it that Lockheed doesn't bribe officials in Japan, because this affects foreign relations we have with Japan, while Lockheed may be perfectly within their private costs to do this. That is an externality, external costs or benefits that can't be gathered entirely by the people involved in making the decisions. That is a rationale for doing it.

The second rationale is its efficiency, namely the government is believed to be the most efficient purveyor or mover of the information, more so than the private sector and more so than any private organization, like Standards & Poors or Moody's or somebody else. The last is the matter of value judgments. You say, look, I think it is inequitable that in such a situation that private corporations operate in a certain way or that there is a maldistribution of—I view it as income—maldistribution of something which we consider valuable, utilities is a sort of catch-all word for that. For example, we think that we ought to have a redistribution of medical services to the poor, even though they can't afford it, because we think that is a good thing. That is our value judgment.

Now, you have to postulate one of those three things before you can argue that it is a useful thing for the government to intrude itself. One has to say, well, where are they? My feeling is that there aren't any maldistributions of utility involved here. You want the poor to own stock, you give them stocks, and so I think we
can give them disclosure. The efficiency question and the externalities question one has to at least identify. We can't measure them very well.

The other question then is, how much is enough? When do you get to the point—this again necessarily drives us back to the essential question that Bob Elliott will be talking about, namely, what are the cost-benefit tradeoffs here? But maybe first you have to postulate at least there is some benefit, because you know there are costs. If you can't identify any benefits, well then we can forget about it because we know the costs are there. If you can identify benefits then you have to ask: are those benefits sufficient to offset the cost? Who pays for it? Who benefits? Clearly, I think it is a good idea, that there is a benefit, if I get $1,000 a week from some unnamed source, or named source, for that matter. Since the cost is to somebody else, there is a redistribution of wealth from them to me. I think that is a good thing, but they may think it is a bad thing. At least we have to say there is some benefit going on and we ought to identify it.

The last question is—what the efficient market tells us—is that, at least so far as publicly-traded corporations are concerned, a lot of the information that otherwise might be provided by auditors is apparently ferreted out by people in their own self-interest. It seems that at least the evidence is consistent with that belief.
(JR): It is also consistent with the other belief that it is not efficient.

Discussion Leader (GB): No, I don't believe it is. You keep citing that there are cases, and I would like to get the references because I don't know about them. I just reviewed all this literature for a book I just finished. Unfortunately, the book is obviously flawed because I don't know of this evidence that Josh has. But even without that, we have questions about corporations or partnerships that aren't traded. Is there a governmental interest in this? And the last question, of which I personally think there is an interest, and that is, in enterprises where there is no market constraint, namely the government itself. What is New York City doing with the resources entrusted to it? What is TVA doing with the resources entrusted to it?

I'm in the middle of a project in which I have written away to all the Federal agencies and asked them, would they please send me their quarterly reports and annual statements and tell me who their auditor is. And I got back a whole—I knew what I was doing, I didn't send it on my university stationery—most of them answered, some of them didn't; most of them don't produce any statements worth a damn. The SEC statement comes out 11 months after the end of their fiscal year, which violates the regulations they impose on corporations, and I have no choice but to buy a share in them. As a citizen, I own them. I can clearly decide not to buy General Motors or anyone else if I don't like them.
I wonder what the responsibility of the AICPA, as representative of the public interest, is in situations where the governmental bodies are not following ordinary rules of reporting to their constituents. So those are the general questions.

(WN): May I start the last one back. First of all, with regard to governmental units, I think you are overlooking the fact that there is a market interest in it, if you happen to be bondholders rather than equity holders. And bondholders are today becoming quite concerned about the financial position of certain municipalities. So I think the market factor does operate on—it doesn't operate on the SEC, the case you cited—but it operates on all the vast number of municipalities and revenue units, that kind of thing.

(MFC): I would like to interrupt here. I suppose George could say it operates on the SEC, too, because pressure would be brought on the Appropriations Committee.

(WN): I mean there are no bondholders in the SEC.

Discussion Leader (GB): Well, then we might get into the question of conflict of interest, between the Appropriations Committee and the people to whom they are appropriating funds and what those people do to the specific members of those committees from which they get their funds. But I'm sorry, I shouldn't have interrupted what you were saying.

(WN): Well, that was just a minor point.

Discussion Leader (GB): That is a good point.

(WN): I think that we do have a market factor operating,
and I think it is going to operate more vigorously in the future than it has in the past. But looking to the broader question of how do you determine how much auditing we should have, how much expenses we should have, I would like to throw out this proposition: a company will spend or should spend as much money on an audit as required to maintain its credibility in the public sector, with all the different kinds of pressures that bear upon it. It needs to maintain its credibility in order to maintain some freedom of action. The amount of auditing that will enable it to do that can not be determined with any one point in time, except by the general observation of what the community demands are, whether they are rational or irrational. Now, for example, today, we are having demands to know what all these illegal payments are. You know that they are really immaterial from a financial standpoint, but somehow they are perceived to be important from some other standpoint. So, corporations have to provide information today on a special basis, but I would suggest that maybe they are going to have to provide this information on a recurring basis. If this requires more audit expense, so be it. Now, that is a hypothesis. I would like to hear reactions to it.

(MFC): You asked the question demands from whom? There are at least two bills in the Congress right now, one introduced
by Senator Proxmire and a much more sophisticated piece just introduced by Senator Church. The assumption is that those bills are introduced by members of the Congress in response to some public demand. I don't know if I have any empirical evidence to prove that to you, but theoretically, that is how these people operate. That is the answer to your question.

(CW): There is a public demand that we know about to some extent. There is a brief that has been filed before the SEC by the National Council of Churches in connection with the illegal acts area. Presumably, that has led to some of Hill's remarks and, I think, led directly to the way that Senator Church's legislation is phrased.

(MFC): The President of the United States thinks that the matter is important.

(JR): I agree with George that it has to boil down to, at least on the theoretical level, to some issue of externality or social welfare criteria, which George calls utility maldistributions. But I think that probably most of the demands can be rationalized, on one of these bases or the other. I think that what we are arguing with George, is that it is not necessary for these benefits to be quantified and measured prior to taking action, because it is very difficult to measure these benefits, as Bob Elliott is probably well aware of since he has been involved in the social measurement project. It is not clear to
me that, if one identifies the benefit but is unable to empirically measure them, that that is not a justification for coming up with a set of requirements, given a certain consensus about the political process. Because it is one thing to say that the benefits probably can be identified but unless I can measure them, since there are some positive costs, I shouldn't take that action. I don't think that is justified because there is an equally forceful argument to the contrary. There are identifiable benefits; I cannot measure them. There are some positive costs, but that, you know, it may imply some actions.
Discussion Leader (GB): Well, I admit, I'm taking what I think is a value judgment, and I don't justify it on any other basis. The value judgment essentially is that in a free society (I hope it doesn't grate anyone's ears. I would think it would fall lightly on those ears) in a free society, citizens are better off making decisions for themselves and not having them being made for them. Unless somebody can...and therefore if you are not sure what to do, if you are not sure whether arresting all women between 34 St. and 67 St. on the West Side will reduce prostitution, and reducing prostitution is a good thing, then civil liberties says you don't do that sort of thing. Now, if you are not sure what to do, you take the action that does not impose upon the liberties of people. I'm saying, if we don't know what the benefits are, or can't measure them, we don't impose costs on people. That is a bias, I admit.

(JR): But, you see, that is precisely what doesn't follow for me that if the benefits cannot be accurately measured...

Discussion Leader (GB): I didn't say accurately, Josh—you keep saying that—I said measured at all.

(LL): Can we get it out of the theoretical? I think that we are not ready for Items 1 and 2 yet. When we begin to run out of energy, and begin to run out of scarce materials, then I think you are going to get Items 1 and 2, but I have to believe that the auditing process will be geared in with allocation of resources only when we become desperate and that is a long way off. As to Item 3, I think we are there now. I didn't go up
to New York, so I can't speak of New York, but in Pennsylvania, many of these municipalities, authorities, school districts, are being audited, many of them by independent public accountants. But where they are not they have got—in the law—they have got the butcher and the baker and the candlestick maker being the appointed auditors and they are making some kind of an audit. But most subdivisions of the state are being audited, not the state itself.

(RE): That is fiscal auditing, now, and I think the particular type of accountability that is needed there might be more in terms of the delivery of the social services that the government unit is supposed to be delivering. And that gets back to Bill's point about whether bondholders are going to hold these people to account. What happens is—you see it here in New York, for example—the bondholders are in effect running the city to maximize the probability that the bonds will be paid rather than to deliver the social services that some people expect of the city.

(RK): Secular corporations, when they go into bankruptcy, the corporation is run to recover the money for the debtors and it is generally in the best interests of the corporation and the stockholders not to allow a situation to get them into bankruptcy,
just like it was in the best interests of the recipients of services in New York not to demand a level of services that would put them into a situation where they were no longer running the city.

(EH): Mr. Chairman, could I rise to a point of order, please? Can I ask somebody to tell me what the subject is right at this point.

Chairman (DRC): I am afraid that I lost track.

(LL): Roman numeral IV, Item 3.

(EH): I just wanted to see if the Chairman knew.

Chairman (DRC): I failed that test.

(RK): Seems like we are getting to Roman numeral IV without having gotten into Roman numeral III.

Discussion Leader (GB): Let me suggest one thing on Roman numeral III. The point here is that if you look back before we had any kind of requirement, you see that there was auditing being done. And if you think about what the interests of private parties are, there is an interest in having an auditor check on the behavior of the steward. Even in a situation where—go back a minute—a corporation is being formed, the people who are the promoters of that corporation know that they have an agency problem. Will the people who are running the corporation run it in the interests of the owners? The answer is, of course they won't, not entirely, and there is a monitoring problem. How do you know whether they are doing it, whether they are not running it in their own benefit, ripping it off for their benefit,
or they are going to run it in the owner's interests? We know no one runs anything in the interest of somebody else, entirely. There is always their own self-interest operating. So, auditors came into the game very early. Go back to the history of auditing. They came into the game with the bondholders in England, checking on their investments in the United States, sending first Price Waterhouse auditors over to check on what was happening with their money. And if you go back much earlier, of course, you find the same thing. Now, given that, the question I was raising is why would not these private parties, operating in their own self-interest, arrive at the optimal amount of auditing? By optimal I mean that an additional dollar spent on auditing would not give you a dollar's return on getting better performance from the manager in the interests of the owners.

(MFC): Let me raise a question. I don't want to prolong the discussion. This started as you say, a long time ago when you were dealing with a finite, relatively small group, at least those who had it within their power to take action or at least to arrive at a decision whether to take or not to take action. It has been suggested that with the development of the corporation and the spread of the separation of ownership and management, that you have a different problem. You do have owners who are not capable of exercising the function of owners as it was when auditing first started. Do you think that changes the situation?
Discussion Leader (GB): I don't believe so, because when anyone buys a share of a corporation, you know, you buy it under conditions in which you can't physically look out. One of the major functions, I believe, that auditing firms have is that they stand as independent parties who will look out for the interests of the shareholders vis a vis the managers and, in fact, report upon them as to whether the contractual arrangements are being maintained.

(RK): They can't do that and finally they have their own self-interest. The auditor is also an interested party.

Discussion Leader (GB): Right, and I'm suggesting that their self-interest lies, and I believe always has been, in doing their job well, because what an accountant really sells, I believe, is his integrity and the accountant has a lot to lose in not doing his job well.

(JR): But it is so true that any individual investor who wants to seek information about the uncertainty of the information that is disclosed to him, if anyone were to do that, he would have to seek some sources. It would involve costs; presumably he would in a free enterprise—completely free—system, presumably he could do that or he could not do that, depending on his own perception of costs and benefits. I think that there is still an externality problem in the social function of providing information that reduces the uncertainty of disclosures. It may well be that the optimal social arrangement is to have auditors fulfill that
function and that will not evolve simply as a result of pursuing self-interest on the part of both parties involved.

(RK): Let me just try to say it a different way, because I am really astonished to even make this argument.

(LL): Are you on privately or publicly held companies at the moment?

(RK): Publicly held.

(LL): I thought we were on Items 3 and 4 of the outline, which is on privately held companies.

(RK): No, we are on private corporations that are publicly traded.

George, that you can sit there and use classical economic analysis on a good which is a public good like information is really surprising. It is obvious that when I don't count your own benefits from the information, because information is a public good and it goes to people other than the people who directly pay for it, then it just almost follows immediately that I will invest less to get that information than is socially optimal.

Discussion Leader (GB): I think that you have a fallacy in the meaning of "public good" in this particular case.

(JR): No, no, I think, that if you analyze situations that there are clear incentives to suppress negative information.

(RK): It is clear that that is why you have under investment in R&D, and why you have government interference in subsidizing,
perhaps, R&D because the people who pay for that don't capture all the benefits in the R&D. It goes to their competitors, and it goes to the economy as a whole. So, that is what Josh has been calling an externality, but basically it is that you don't capture all the benefits in your investment.

Discussion Leader (GB): Let me ask you this question, Bob. Say, you are a shareholder in General Motors, and you get an audit report that says, "we have examined the books of account, etc." To what extent is that information not totally captured by you as a shareholder. You can now sell your shares to somebody else who is likely to buy them, and you are fully aware that they are buying with the knowledge of some information.

(RK): But nonshareholders get it too, and they can decide not to buy it.

Discussion Leader (GB): That is the advantage, but if nonshareholders were to get no information, that is information.

(JR): But, George, that doesn't follow.

Discussion Leader (GB): Are you likely to be able to sell your shares in a company that does not produce audit reports?

(MFC): Yes, there is another theory. I'm just trying to clarify here...
(RK): No, George, you are not saying zero or the current level of auditing. I am trying to find out what the optimal level of auditing is. I'm saying that, because it is a public good and because the people who pay for it don't capture all of the benefits from that service, you get less overall investment in that good than is desired in the economy.

(JR): I think it is clear, if you analyze it, that there is a clear incentive to suppress negative information and nothing that free enterprise will do will prevent that from happening without some kind of interference.

(MSH): Also, George, it is not clear, even if you talk about the level of auditing being influenced by the stockholders, it is not clear—the mechanism isn't clear—by which they do that. If all stockholders could get together and form a coalition and then in a game sense, game theory sense, could exert their influence against the other parties, that would be one thing, but stockholders are very diffuse. It is not clear that in some obscure way the market mechanism operates to deliver for them what they in fact could theoretically deliver for themselves if they formed a coalition, that is if the stockholders formed a coalition, which they can't do. So, I just can't buy your argument.

(RK): You can't possibly think about coalition formation for stockholders. The idea that they are going to
sit back and determine the optimal level of auditing when there are 300,000 stockholders and the number changes every day. It is just not an interesting way of looking at that problem.

(JR): So, you have got to have a social arrangement.

Chairman (DRC): I will agree with that. Chuck, did you still want to make your comment?

(CW): George has implicit in the question after Roman numeral III an assumption, which I think we ought to recognize, and it is that an audit is the best way to go about getting the benefit we seek, which is to prevent shareholders from being hurt by receiving misleading financial information—financial information, which isn't a lot. They may be hurt for other reasons, market actions, and so on. And I think, indeed, that fundamental question needs to be addressed. My guess, roughly, is that we have about a billion dollars a year of fees that are paid to audit public companies in this country, and it would appear, notwithstanding the size of some of the debacles, that that would build a heck of an insurance fund, along the order of the SIPC or the FDIC, etc. And it is an interesting thing to contemplate, as one who loves his profession and makes his living from it, that that might be a better way to go about the ballgame, from a cost standpoint.

(LL): We have been through that.

(MFC): It is no-fault insurance.

(LL): Yes, we have gone through that exercise quite some time ago.
(WN): In a little different fashion, namely that the auditing firm would be the guarantor or the insurers.

(RK): The incidence of fraud and malfeasance may not be the same under both institutional arrangements. So, what seems like a good insurance fund under the current scheme, may not be too good once you get away from that system.

Chairman (DRC): I think that—if it is fair to say—I think that was our general conclusion, that the incidence would change, if the mechanism changed, but I think we should really move on to the next subject.

(WN): May I ask one final question? George, you made a comment earlier about a shareholder selling his shares to an outsider who didn't previously own shares and who didn't have an audit. The implication seems to be that he wouldn't be able to effectuate the sale because he didn't have an audit.

Discussion Leader (GB): No, he could effectuate the sale at a lower price.

(WN): Now, I can't square that with what seems to me to be the implication of your efficient market theory, that the auditor's statement doesn't contribute anything when it is published.

Discussion Leader (GB): Let me make that clear. What I was saying there, I think, is not that the audited statement is meaningless or is not desired. I have written in another article that I think the function of the statement is not to provide information to people at the time of its publication, but to provide information that a reputable CPA firm has looked at the
books of account and, if something was wrong, it would be published in the financial statements, or some action was taken, and although you don't see it there, you know that they have done this and that they are putting their reputation on the line. So, in fact, the existence of the financial statements is extremely important. At least I think it is important, and I take my judgment for that from the fact that financial statements were presented long before they were required by anyone. The private market caused their creation.

(WN): But in the efficient market theory, why wouldn't it be sufficient, if I follow your line of reasoning, for the auditor to just publish a certificate and forget all the rest.

Discussion Leader (GB): Because the statement itself is a more efficient means of establishing the fact that the auditor not only did that, but he did something specific. He said: "here are the numbers," rather than saying "I just did something." It is a way of being more explicit about the existence of auditing, and also that the financial statement has been—what he is really doing is certifying, to use an old term—the existence of that statement made by the stewards of the enterprise.

I would just like to very briefly say one thing to end my part in the discussion. First of all, I don't think it was worthwhile going on, especially for this group, to the whole question of externalities and whether the market would operate efficiently if there is a free market for information that is a
public good. I happen to be working on a paper on that now and I will send it to anyone who wants it. Let me say that while my colleagues are correct in my opinion, in saying that there is some public good aspect, I think they are incorrect in saying that it is very important. Also further than that the free market, so-called.—I don't like to use these terms because people automatically decide they don't like it or like it because of some prior assumption—is such that you know that you buy a share of stock in a company, or anything else, with certain expectations that there is going to be some misinformation that you are buying at the same time. If you buy a car from a dealer, you know that the car isn't going to be exactly as you expected; something is going to be wrong. Usually, the dealer stands behind that car, and he gets the business. More business comes. Sometimes there is a mistake being made. Some of them are cheats; some of them are not. But generally speaking, if you look around at a variety of things, I think we see in a wide range of aspects that people don't cheat the public over long periods of time just to stay in business.

I think that what the auditor does and it is very important to do is to put his integrity on the line and say: "If something is wrong here, I'm going to catch it because the reason you are hiring me and my name, my firm's name is behind the statement, is because I have a reputation for not knuckling under to management, for not allowing numbers that are designed to defraud to get through,
and for doing the job as is expected of me." I think auditors, in fact, do that job, and what we see is an occasional case in which they either slip or in which the rules of the game have changed somewhere along the line, and they were never paid to do something that later was determined that they ought to have done in hindsight. So, I think the system has worked before quite well and, in fact, works rather well now, and what we have mostly is additional costs imposed on the system.

(JR): Only a very brief comment, a brief comment on the car analogy. It just so happens that the social benefits of cars are quite appropriately signalled by the price of cars, including the implications of misinformation about cars, whereas this is not the case with information, because the social benefits of information are not captured through any positive market price for information, because it doesn't exist really. And this is really what highlights the aspect of the public good nature of information. So, if there is any analogy to be made, I don't think the car analogy is the best in this case.

Discussion Leader (GB): I don't see the use of carrying it on further. All I want to say is that my silence does not indicate assent.

Chairman (DRC): I'm sure you are not the only one who would like to make that stipulation.