Response of Touche Ross & Co. to The Commission on Auditors' Responsibilities on its Report of Tentative Conclusions, July 22, 1977;

Touche Ross & Co.;

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RESPONSE
of
TOUCHE ROSS & CO.
to
The Commission on Auditors' Responsibilities
on its
Report of Tentative Conclusions

July 22, 1977
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TOUCHE ROSS & CO.

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Report of Tentative Conclusions

July 22, 1977
Commission on Auditors' Responsibilities  
1211 Avenue of the Americas  
New York, New York 10036  

Gentlemen:

We appreciate the opportunity to express our views on the Report of Tentative Conclusions of the Commission on Auditors' Responsibilities. Our response is organized as follows:

- Summary (substantially the remarks we made at the Commission's Public Meeting on June 22, 1977)
- Detailed Comments on Sections 1 through 11
- Appendix A - Applicable Excerpts from our statement for the record of hearings by the Subcommittee on Reports, Accounting and Management of the U.S. Senate Committee on Governmental Affairs on The Accounting Establishment: A Staff Study.

We would be pleased to further discuss our comments should the Commission so desire.

Yours very truly,

Touche Ross & Co.
Summary

Touche Ross & Co. has long been concerned about the responsibilities of auditors. We believe our record indicates a continuing awareness of current developments, and a willingness to step up to needed improvements in auditing standards and procedures well before it has been possible for professional consensus to be reached.

We are substantially in agreement with the Commission's recommendations. Though there are certain matters with which we disagree or believe need further study, we want to compliment the Commission on an extraordinarily thorough coverage of the auditing profession, never before accomplished.

Admittedly, there is a considerable built-in reluctance -- not in a little way related to liability exposure -- which causes the auditing profession to slowly evolve, rather than make revolutionary changes. Therefore, it is good that the Commission gave us so many ideas at once, to focus our attention on a combination of concerns which we otherwise tend to deal with individually. Experience shows that fractionalized standards are difficult to write and to explain in context to professional staff. To the extent that the Commission's actions will make progress less traumatic, we have a vital interest in these deliberations.

There are a few overriding observations we think should be made at this time:

1. Even though certain conclusions of the Commission seem desirable, we may disagree about whether conditions exist, at least in the seriousness suggested by the Commission, so as to mandate the adoption of a recommendation.

2. Many of the Commission's recommendations have a flavor of social desirability in them. Care must be taken that the auditing profession is not asked to provide assurance beyond its attainability. While auditors may have to learn additional disciplines to accomplish some of the recommendations, we are in favor of such an extension of expertise so long as it has a reasonable relationship to the fundamental social position appropriately occupied by the auditing profession. We may be going too far afield to sweep, into the assurances given to financial statement users, a coverage of other disciplines such as law, actuarial science, geology, appraising and so on.

3. Although we do not intend to overemphasize this problem, we believe that the litigious environment is serious, and despite the reasonableness of some of the Commission's suggestions, implementation may not be practical without
liability relief — at least temporarily, as through the
safe harbors recommended by the Commission. We would
prefer, instead of safe harbors, or in addition to them,
that much clearer standards be written, but we are not
prepared at this time to offer detailed alternatives. In
any event, something more than "reasonable and proper" or
"due professional care" is needed for the underlying
standard.

4. Many of the Commission's recommendations will carry a
significant cost with them. We, too, do not know how to
approach this except on a recommendation by recommendation
basis, but we urge experimentation, perhaps in stages,
before a final determination of the need for auditor
involvement is made.

5. There appears to us to be a fundamental thought in the
Commission's recommendations that corporate audit
committees have the ultimate responsibility for client
integrity and accountability. Indirectly, the Commission
may have ordained many of the duties of audit committees
without really addressing whether their members may
reasonably be able to perform all that is asked of them.
In general, we agree that directors should have these
responsibilities, but provisions must be made for providing
advice and counsel to such persons. As we see it, their
expertise will even have to be broader in concept than that
of the independent auditor. The synthesis of a good audit
committee member would include accounting, auditing, law,
business management, finance and considerable prudence. It
is doubtful that a sufficient number of individuals
maintaining these skills and disciplines -- especially
through service in their own organizations -- would be
available to fill the audit committee needs throughout the
United States. Further inquiry needs to be made into this
subject.

6. A large proportion of the recommendations apply to publicly
held companies, and might very well be impracticable for
smaller, privately held companies. As there is a debate on
"big GAAP" vs. "little GAAP," one could envision a debate
on "big GAAS" vs. "little GAAS." That, however, may not be
the issue. Auditing standards -- those inscribed almost
thirty years ago -- should be invariable regardless of the
audited entity's size. Procedures -- and by that we mean
interpretations of the basic auditing standards which are
most often promulgated in statements on auditing standards
-- might possibly be variable, particularly where a
procedure is required of the auditor because of its social
significance to absentee owners.
7. Underlying many of the Commission's recommendations is the thought that the auditor is a reporter on financial information, not its originator. This should be emphasized. If that message can be communicated to the public and if the Financial Accounting Standards Board can achieve adoption of one of its tentatively stated objectives of financial statements -- that financial statements are designed for investors and creditors having a reasonable understanding of financial accounting and reporting and a willingness to take the time necessary to study financial reports -- we might be able to close another gap. Perhaps a user of audited financial statements should also be expected to have a reasonable knowledge of auditing standards in order to understand the degree of reliance he may (or may not) place on the auditor's association with financial information.

8. The release of the Commission's Report of Tentative Conclusions somewhat coincided with the Metcalf Staff hearings, undoubtedly adding a greater degree of finality to the Commission's conclusions than might otherwise have been the case.

We are particularly concerned that corporate management and audit committee members may not have given full recognition to the impact of the Commission's recommendations, especially from a cost standpoint -- both fees as well as time of company management and personnel -- and we hope that the Commission encourages additional participation, even after the issuance of its finalized report.

Highlighted in the remainder of this summary are comments on individual sections of the report.

Section 2 - Forming an Opinion on Financial Presentations

We totally agree with the Commission that the word "fairly" should be eliminated from the auditor's report as we think it can no longer be successfully defined. But it appears to us that the Commission's recommendations about selecting among alternatives need further study:

1. Though we agree that auditors should make an evaluation of the cumulative effect of management's judgment on the selection of accounting principles, we think that the issue is one of defining substance, the focal point of the Commission's recommendation. Until the FASB specifies financial statement objectives and a conceptual framework, it is not possible to be unequivocally responsible for assessing substantive compliance with promulgated accounting standards.
2. After circumstances are considered, there are not that many free choice alternatives. In any event, standards for evaluating the cumulative effect must be promulgated for those restricted instances.

Section 3 - Reporting on Significant Uncertainties in Financial Presentations

While we agree that auditor's reports should not be qualified for uncertainties -- even where a "going concern" question is involved -- we are concerned that the adequacy of disclosure of uncertainties could be as difficult to evaluate as it presently is in deciding when to apply a qualified opinion.

In this regard, the FASB should be encouraged to lift out of its broad conceptual framework project the issue of ordering financial statement disclosures according to their degree of factuality vs. interpretation. Naturally, information on uncertainties would tend highly to the interpretive.

Section 4 - Clarifying Responsibilities for the Detection of Fraud

The Commission recommends that "the auditor should be concerned with all controls that have a significant bearing on the prevention and detection of fraud." We agree that auditors have an obligation to search for fraud. We think that an alertness to its possibility is essential and will in combination with other Commission recommendations, raise the auditor's discovery rate substantially. We point out that SAS No. 16 calls for the auditor to plan his examination so that he can give reasonable assurance the financial statements are not materially affected by errors or irregularities. Even though less than material fraud could be discovered during the audit by this planning approach, we ask that the Commission reconsider whether the auditor should change his planning process; to require the auditor to study and evaluate all "controls that have a significant bearing on the prevention and detection of fraud" could seriously affect the economics of auditing because:

- Requiring a review of all internal control systems when there is a more economical means to substantively audit the area could eliminate the auditor's prerogative of testing, both as to quantity and design; and

- It is not feasible to create internal control systems providing virtually absolute insurance against management or collusive fraud.
Section 5 - Corporate Accountability and the Law

It is essential that there be a clear specification of those illegal or questionable acts for which the auditor has to search. Furthermore, materiality standards, if not relative then absolute, must be provided. Clear definitions are needed for managements to systematize the gathering of information, and auditors are unable to perform an intelligent search, even for material items, without quantification of what is involved.

We are not against auditors exercising common sense, but independent auditors can not monitor compliance with corporate codes of conduct in a manner which surpasses the inherent effectiveness and specificity of the codes themselves.

In this regard, we feel particularly that, because laws and regulations are involved, lawyers need to be brought directly into all of these determinations in individual audits.

Section 6 - The Boundaries of the Auditor's Role and Its Extension

In general we are in favor of extending the auditor's role in keeping with an accounting and auditing orientation, but we have a concern with this already mentioned: the Commission's recommendation that auditors should be required to review and test systems of internal control to form a conclusion on their functioning during the year seems excessive. To require systems tests in all areas will greatly increase total audit effort and cost.

We are in favor of gradual experimentation on the issue of management's reporting of internal control weaknesses, as we are uncertain about the understandability of these matters to financial statement users at the present time. Consideration should be given to making such reports available only on request.

Section 7 - The Auditor's Communication with Users

We agree that the auditor's standard report should be changed, but foresee difficulties with "standardized alternative phrases or paragraphs." Such a format may be much the same as we presently have -- only longer. The auditor should make a series of positive and reasonably factual statements, and should not be asked to state the obvious merely to make a longer report. For example, saying that "auditing procedures were adequate in the circumstances to support our opinion" is unnecessary.

In a sense, the auditor's report would appear to be a conglomerate of issues which are topical at any point in time. This is good provided there is an on-line, real-time, auditing standards board determining what those topics should be and devising a way to dispense with matters no longer topical.
In addition to our agreement with the idea of the proposed report by management, we are in favor of experimentation with the presentation of reports of other experts. This should apply not only to lawyers, but could be extended to any profession whose judgment has a significant impact on the financial statements.

We think it is time to stop sharing audit responsibilities between primary and secondary auditors on a single entity, i.e., including its controlled subsidiaries. This should be studied, and if it could be so resolved, would substantially eliminate the question of how to report on the shared responsibility.

Section 8 - The Education, Training, and Development of Auditors

We think the Commission's proposal of a four-year liberal arts undergraduate program and a three-year graduate professional program would not be of significant additional help in preparing persons for the profession. "On the line" experience is necessary for the understanding of auditor's responsibilities and objectives.

Section 9 - Maintaining the Independence of Auditors

We maintain that, despite significant fee pressures and competition, there is a resulting effort to become more efficient in auditing and not to reduce audit scope below what is required.

With the Metcalf Staff believing that there is insufficient competition and the Commission suggesting there is too much competition, this may be an indication that competition is not the issue -- the nature of services and their quality are what's at issue.

Even when faced with intensive price competition, we and other firms have added procedures in recent years which have been costly. In our case, we have added about five to seven percent to total audit costs and for this reason we have a large investment presently in the refinement and adoption of a more efficient and conceptual approach to auditing.

We believe the subsection of the Report dealing with the overriding effect of time pressures on the quality of the audit is the most incisive area of the Commission's report. We agree that "audit failures" are probably due to mistakes in judgment because of excessive reliance on client representations. But the Commission may have lost focus of a major part of the excessive reliance issue by stating that "although there are other factors, the Commission believes that excessive time pressures are the most pervasive cause of audit failures." (Our emphasis.) Among these other factors is one we believe is more important: guidance is needed on what the auditor should do with representations of extreme difficulty in
substantiation, or perhaps not susceptible of outside
documentation. Another factor is defining the "effective date of a
transaction," which we think the FASB should put on its agenda for
early treatment.

Unreasonable client time demands should be resisted, to be
sure, but it is hard to conclude that they cause the auditor to
compromise his independence. The Commission may be underestimating
the energies of dedicated professionals to both do it right and do
it fast. Some tension is beneficial, at least in a productivity
sense.

Of concern to us is that the Commission reported in the
body of the tentative report the comment that "58% of respondents
still in public practice and 68% now out of the profession have
signed for completing audit steps (not covered by another
compensating step) when they have not performed the work." The
greater detail included in the Commission's survey report shows that
only 3% did this in any way which would reduce, in their judgment,
the overall audit quality. Therefore the major problem may not be
in audit quality, but in documentation. Documentation is, of
course, important, as its absence or incompleteness has contributed
to unfavorable results for accountants in problem cases which may
not have been, in the final analysis, "audit failures."

A major factor suppressing tendencies to sign-off audit
procedures without performance is indicated as being the level of
review employed by a firm. We agree, and have had a high level of
review throughout our firm's entire existence. The entire
profession should adopt a thorough, preissuance independent review
of the audit work as well as the financial statements and auditor's
report.

The Commission has recommended "that individual public
accounting firms immediately undertake to conduct studies to
determine the extent of the conditions revealed by the Commission's
study and the effects on their practices." SAS No. 4 already calls
for firms to maintain an inspection program to monitor compliance
with professional standards. All of the larger firms perform some
type of periodic review of each office's practice quality. In our
firm, a "Task Force Review" (in-depth review of selected
engagements) is alternated biennially with a "Technical Center
Review" (a more restricted coverage of overall quality aspects) so
that each office has annual consideration of its professional
standards compliance. We believe this approach should be
emphasized, and we hope the Commission did not have in mind a study
of the integrity of a firm's professional staff as a means of
ferreting out past defects. It seems to us that the emphasis should
be on high standards of conduct, with the admonition (based on the
Commission's survey results) that disregard of those standards
should be summarily dealt with.
We also note that none of the material published in the Commission's Report of Tentative Conclusions, either in the body of the Report or in the more detailed appendices, articulates the strategies involved in the survey, the kinds of results expected from the questions as worded, and the variety of possible conclusions, in addition to those that the Commission and the researcher believed were the most probable conclusions. This kind of information would establish a better setting, in our view, for the survey's critical results.

Section 10 - The Process of Establishing Auditing Standards

While we have been pleased with the output of the Auditing Standards Executive Committee in recent years, we are generally in favor of an auditing standards board, full-time and smaller in size -- we suggest nine members. Some of the features of the auditing standards board would be:

1. As much openness as possible; public hearings would be appropriate for deliberative sessions

2. A larger staff to assist the proposed board

3. A board member's term of three years without provision for renewal

4. No requirement for complete independence on the part of a board member (in the sense of being unable to return to his previous firm).

5. Serve as the focal point for auditing research.

To charter the new auditing standards board, we believe that a review committee composed of representatives from the profession and other appropriate sectors should be created promptly in the fashion of the FAF Structure Committee.

Section 11 - Regulating the Profession to Maintain the Quality of Audit Practice

The Commission suggests that firms have intensified their practice control activities in response to highly publicized "audit failures." We think that perhaps more important is the concern over being unable to convince a lay jury or judge that an audit was properly conducted in conformity with generally accepted auditing standards. We strongly agree that, unfortunately, there is a considerable element of wasteful, defensive auditing." Most of this has been directed toward documentation and represents an excessive societal cost by the "burden of proof" requirements of the Federal Securities Laws.
DETAILED COMMENTS ON

SECTIONS 1 THROUGH 11
SECTION 1
THE INDEPENDENT AUDITOR'S ROLE IN SOCIETY

The Commission's Tentative Conclusions

- "There is a need to clarify the auditor's role.... The underlying purpose of an audit (is) its social function."
- "The role of the independent auditor in improving corporate accountability can be significantly strengthened by closer, more active cooperation between boards of directors and auditors."

The Need to Clarify the Auditor's Role

We are in substantial agreement with the statements by the Commission concerning the need to clarify the auditor's role. There is no question that many users of financial statements have an erroneous impression of the auditor's role, and therefore an exaggerated expectation of what is conveyed by the auditor's association. Many users indeed believe that the auditor's standard opinion attests to the financial soundness of the company, as is often asserted when investments become worthless or do not result in the return anticipated.

These misunderstandings are not surprising. Although many of the public's expectations of auditors probably cannot be met because of costs disproportionate to benefits or because they are not within the reasonably imaginable expertise of auditors (and, in some cases, of anyone else), there are still many areas explored by the Commission in which auditors can do more to fulfill their appropriate societal role. Efforts to inform the public of the present limited role of auditors have been unsuccessful primarily because auditors have not recognized that expansion of the role is needed despite the problems of oppressive litigation.

The Federal Securities Laws in general require that the auditor be able to prove having performed a satisfactory audit in accordance with generally accepted auditing standards when challenged, as opposed to a plaintiff having to demonstrate that the auditor did not. This arrangement has been a very prominent counterproductive force in restraining the appropriate extension of the auditor's role. It is entirely true that "Court decisions...must be considered carefully because a decision is usually closely related to the facts of a particular case" (p. 2). (This is not understood by the public, and in our comments in Section 9 we discuss whether this fact might have been given insufficient credence by the Commission in its discussions of "audit failures.")
It is significant that numerous recent statements on auditing standards have emerged because of requirements established for publicly held companies by the Securities and Exchange Commission. Approaches acceded to by the SEC in recognition of the auditor's concern about role extension -- differential disclosure, unaudited footnotes and a "safe harbor" (for published forecasts) -- are not sufficient of themselves. We agree that an overall reconsideration of the auditor's role, particularly including responsibility to whom, for what and at what financial peril, is needed before coordinated and coherent advances of the auditing profession beyond its present levels can occur.

The Audit Function

"The underlying purpose of an audit (is) its social function" -- The Commission's discussion of "accounting as a means of social control" focuses on "accountability." We are unable to find a clear and complete definition of "accountability" in the Report of Tentative Conclusions. To say that "...the entity is accountable for every transaction" (p. 3) is vague; no specific reason is given and no specification of the intended beneficiaries is made.

The nearest we can come to a definition in the Report is found in this citation (p. 4):

"Directors, managers and administrators have this duty of accountability, a duty to demonstrate the quality of their performance within the constraints of the limited responsibility which has been entrusted to them. It is in this context that society has conceived the audit function whereby the performance of, and the account of their performance, submitted by the directors, managers, etc. may be subject to some scrutiny on behalf of those to whom the directors, managers, etc. are accountable." (Emphasis added.)

Perhaps the Commission intended the definition to be encompassed within the passage (on page 5) that "Users of financial statements need assurance that management has fulfilled its stewardship responsibility by establishing and supervising a system that adequately protects corporate assets." There are numerous other references to accountability in Section 1, but they all speak only in terms of its consequences rather than its full meaning.

While the Commission's views could be inferred from the text, we think it is important that accountability be more precisely defined in the Commission's final report, since it is proffered as the fundamental purpose of accounting. Retaining the present wide latitude invites exponential implications for auditors' responsibilities.

1.2
"Accountability," as used in the Commission's Report, might be an objective of accounting already overemphasized. For example, current Congressional and regulatory activities in the areas of "illegal or questionable acts" suggest that legislators and regulators may be uninformed as to the limitations of both accounting and auditing to accomplish what they intend to prescribe. There should be greater deference to the primary purpose of financial accounting ("production of financial information for decision making"), and we hope the Commission will be able to incorporate in its final report the Objectives of Financial Statements now expressed in tentative form by the Financial Accounting Standards Board as part of its project on the Broad Conceptual Framework for Financial Accounting and Reporting. There may be a tendency to lose sight of the primary purpose of accounting in emphasizing it as an element of social control, not fully coordinating with the FASB progress.

We recommend that the Commission acknowledge the fact that current historical based accounting does not, by its very nature, provide an adequate measure of accountability (either performance or stewardship). Much of the public's disenchantment with auditors' performance might very well be related to deficiencies in the present accounting model and inadequacies in accounting standards under that model, which auditors by their Code of Professional Ethics must observe. As the Commission notes (p. 7): "In general, if an accepted accounting principle, such as historical cost, has limitations, audited financial statements remain constrained by those limitations."

Since the Commission asserts that "(a)n audit provides reasonable assurance that management has fulfilled its (stewardship and performance) responsibility" (p. 5), the inverse relationship between "reasonable assurance" and the constraints of the established accounting framework need to be better understood and reconciled. We believe it will not be possible to enhance the public's understanding of the auditor's role until there is considerable advancement in specification of the accounting framework, as more fully discussed in Section 2 of this response.

The Commission also indicates (p. 7) that "(t)he existence of other controls places limits on the extent of assurance needed from independent auditors." Among these are the control over management by the board of directors, and presumably by the audit committee. Other societal controls (the press, analysts, regulatory agencies, litigation and the securities market) are mentioned.

We believe a substantial burden for control must be placed elsewhere than on the independent auditors. While an audit should be responsive to the degree of control exercised by outside institutions in general, and to the degree of control exercised within the entity by other means, the auditor should not be held
responsible to totally compensate for defects that may exist in other control forces. In short, the auditor cannot be the panacea equalizer of all controls. This raises the issue of adequacy of standards for boards of directors, audit committees, and many other control forces. Although the Commission must necessarily limit its detailed considerations to auditors, it would be proper, in our view, that an articulation be given by the Commission of at least the primary responsibilities of these other parties having a position of control over management.

The Auditor's Relationship to Parties Interested in the Audit Function

The Commission can not overemphasize the importance of frank communication between management and the auditor as a means of obtaining audit evidence sufficient to give the auditor a sense of satisfaction concerning audit conclusions. It is particularly fitting that the Commission chose, as an example of a threat to the present auditor/management relationship, the recent efforts by the Internal Revenue Service to attempt a "fishing expedition" into accountants' working papers without specifying matters for which the search was to be performed. In the recent Johns Manville case (footnote 21, p. 10), litigated at no doubt a significant cost to the defendants, the IRS was dealt a setback, which could very well be temporary unless the Commission in its final report comes out strongly against such incursions. For example, in another recent case,(1-3) the Internal Revenue Service was told that it was inquiring beyond its informational needs via some of the "Eleven Questions" relative to illegal and improper payments (the "slush fund questionnaire"). This matter is now being petitioned for a rehearing and may be further appealed.

We are concerned that the Commission, in discussing management's responsibility for financial statement representations, has inadvertently endorsed the popular belief that there are a multitude of free choice alternative accounting methods. Although management must "choose among accounting methods" (p. 10) and has opportunities for "biased actions involving...outright misrepresentation" (p. 11), we question the inference that this leads to, "more commonly, taking advantage of the many gray areas in accounting measurement." The Metcalf Staff Study's(1-4) allegation of unbridled free choice was demonstrably deflated in the response of the Financial Accounting Foundation to the Staff Study: of the free choice alternatives extant some five years ago, only a few still remain.(1-5) And if one considers Statement on Auditing Standards No. 5 on "The Meaning of 'Present Fairly in Conformity with Generally Accepted Accounting Principles'...," the only three free choice alternatives important enough to mention, as a practical matter, are in depreciation (straight-line versus accelerated), inventory valuation (LIFO versus FIFO or equivalent), and investment credit accounting (flow-through versus deferral).
The accounting and auditing profession suffers from anxiety created by the continuous suggestion of the existence of many free choice alternatives. Thus, we think that SAS 5 did not go quite far enough. Though it avers that the selection of an accounting principle, where there appears to be more than one choice, should be substantially dependent upon the circumstances, it quixotically awaits the specification of circumstances by the FASB. Auditors and managements must and do apply circumstances without FASB specification. When circumstances are taken into account, there are far fewer alternatives indeed.

In discussing the auditor's relationship to financial statement users (p. 11), the Commission indicates that potential shareholders and creditors are not owed the same responsibility by auditors as those who have existing financial interests in an entity. In a legalistic or "accountability" sense (not clearly defined, as discussed earlier herein), this is undoubtedly true. However, because of the operation of the market system in the United States economy, it does not seem useful to make this distinction in any way which would influence the auditor's performance. If anything, the auditor's role today is inverted:

Consider a small company, owner managed, where the independent accountant is asked to prepare financial statements only for management's use. Limited audit procedures are often employed, and because of the restriction of the financial statements to internal use, generally accepted accounting principles (in the area of disclosures) are not followed to the fullest extent. Should, however, the accountant become aware that those financial statements are to be presented to a financial institution for the purpose of considering whether credit should be granted, almost all of the omitted auditing procedures and disclosures must then be performed.

"Closer, more active cooperation between boards of directors and auditors" -- As to the auditor's relationship to the board of directors, we emphatically agree that "the role of the independent auditor in improving corporate accountability can be significantly strengthened by closer, more active cooperation between boards of directors and auditors" (p. 12). Many of the comments in our response are directed toward "closer, more active cooperation." We believe much has already been achieved, although much more could be done.

We endorse the Commission's recommendations for the use of boards of directors and audit committees for the purposes of initial engagement and retention of the auditor and the negotiation of his fees. Substantial achievement of these goals is beginning to occur in publicly held companies, focused on by the Commission in its Report (p. xii).
In the final paragraph of Section 1 the Commission again suggests too great a problem, in our view, as to the relationship of accounting standards to a company's circumstances, with the statement that: "The possibility of abuse of accounting methods is a key area for outside directors to probe." If there are truly available options in material or potentially material matters, the audit committee or the board should be apprised of these by management and the auditors, who should not have to be "probed."

We also suggest that greater attention be given in the Report of Tentative Conclusions to the qualifications necessary for board of directors' or audit committee membership. The Commission's statement that "Outside directors should consider the corporation's total audit needs and balance the work of internal auditors and independent auditors in evaluating controls and management's supervision of them" is vague. Standards of sufficient specificity are needed to assist directors in concluding as to such a balance -- and we think few directors have a sufficiently comprehensive background to be able to do this without specification as well as expert advice.
Footnotes to Section 1


(1-2) Our emphasis in discussing "accountability" relates to the fact that there are varying views of its meaning, without the Commission on Auditors' Responsibilities specifying its own view. For example:

a. The Report of the Study Group on the Objectives of Financial Statements provides an extensive discussion (in Chapter 4) on "Accountability and Financial Statements." This represents a broad view of the beneficiaries of "accountability."

b. The FASB's Tentative Conclusion on Objectives of Financial Statements of Business Enterprises discusses stewardship and management performance as being more restrictive, because the FASB has tentatively concluded that the beneficiaries are only investors and creditors.

Certainly there are other proposals (e.g. an unspecified accountability of public companies to the general public, as suggested in the Metcalf Staff Study), all pointing to a need for adoption of a uniform definition.


SECTION 2
FORMING AN OPINION ON FINANCIAL PRESENTATIONS

The Commission's Tentative Conclusions

- "The auditor must evaluate:
  . the choices made by management among alternative principles,
  . the appropriateness of the principles applied in the absence of formal or detailed accounting pronouncements, and
  . the cumulative effect of the decisions on selection and application of accounting principles."
- "...the continued emphasis on 'fairness' as a standard is not fruitful -- the word 'fairly' should be eliminated from the auditor's report."

The Expectations of Users

The Commission is correct, of course, in giving as a user expectation that the auditor evaluate whether financial statements are "misleading." That term appears in the Federal Securities Laws and also in the AICPA Code of Professional Ethics, Rule 203. Once the financial statements have accomplished what we will call "nonmisleadingness," the auditor's responsibility then is to evaluate whether the financial statements are fairly presented in conformity with generally accepted accounting principles. We recognize the frailties of "fairly presents." But we think that "nonmisleadingness," while sounding commendable, implies as much as or more than "fairly presents," and may be even more subject to misunderstanding by the user of financial statements.

There have been a number of situations (described by the Commission as "audit failures") where the auditor believed the financial statements were not misleading; nonetheless he was accused of contributing to misunderstanding by the user. Because the judiciary is also not uniformly informed(2-1), the auditor, along with management, was adjudged to have been guilty of "misleading" the users.
To be critical of "fairly presents" and to recommend excision of "fairly" from the auditor's report may give the appearance of improvement, but represents no real progress if the meaning of "misleading" as used in the AICPA Code of Ethics and Federal Securities Laws is not specified.

The Commission states (p. 21) that: "Present standards require the auditor to use judgment to see that the selection and application of particular accounting principles do not produce a misleading result." No challenge by the Commission seems evident. We think it could equally be said that nonmisleadingness "is an empty box" and that by nonmisleadingness certain advocates mean that something agrees with their biases. (2-2) We urge that the Commission consider the continued appropriateness of Rule 203 of the AICPA Code of Professional Ethics, and at least conjoin it when concluding (p. 14) that efforts to analyze "fairly presents" are not fruitful. This is discussed in greater detail below.

Of course we agree that further exploration into the nature of generally accepted accounting principles and generally accepted auditing standards is necessary, so long as the users of financial statements are informed of the results of such exploration. The understanding by financial statement users of the many judgments and decisions that must be made about the selection and application of accounting principles must be enhanced in the process, so that they are in a position to evaluate, as they should, whether they agree with management's decisions and the auditor's approbation. It is most important that the user understand what was done, and not that he personally agree with it. With understanding, the user is in a position to make a rational decision.

The Guidance Provided by Generally Accepted Accounting Principles

We note with approval the Commission's ascribing to management the responsibility for using accounting principles that reflect underlying events and transactions. The principles must, of course, be appropriate to the underlying events and transactions both individually and collectively. Thus, the Commission suggests that the auditor should object when literal, but not substantive, requirements of accounting pronouncements have been met (p. 16). The considerable difficulty not addressed by the Commission is in ascertaining when the substance of an accounting pronouncement has been served. Obviously at extremes this should be apparent, but the gray area is so broad as to make a requirement for substantive observation of accounting standards, without more specification, simply unworkable.

We have already referred to the AICPA Code of Professional Ethics. Rule 203 requires that, should the observation of a promulgated generally accepted accounting standard result in a misleading presentation, the financial statements should properly
depart from that standard in order to avert misleadingness, and the auditor should comment in his report that such departure has occurred.

Our firm, on two occasions, has taken avail of Rule 203 with respect to publicly held companies. To our knowledge, this has been done by other firms even less frequently. There seems to be an extreme reluctance to depart from promulgated standards because they are more and more tightly drawn, and misleadingness objections could often appear to relate to a disagreement with the concept underlying the accounting standard.

Until the FASB specifies (as it is now in the process of doing) the Objectives of Financial Statements and the Conceptual Framework for Financial Accounting and Reporting, it will not be possible even by fiat to require that auditors unequivocally be responsible for "substantive compliance" with promulgated accounting standards. An example is the FASB's question about the proper perspective of financial statements -- the income and expense view (matching is all-important and the balance sheet is a residual) versus the asset and liability view (the differences between the values of economic resources and obligations at two points in time, after eliminating capital transactions, represent income for the intervening period). This soon-to-be-settled argument has often given rise to later challenge that substance of an accounting standard has not been observed, when in fact the culprit may have been inconsistent perspectives included in a single set of financial statements.

Touche Ross is certainly in favor of "substance," but "substance" is a term also needing a definition. The framework for that definition will be provided by the FASB, and hopefully soon.

In referring to deficiencies in present generally accepted accounting principles (p. 16), the Commission may have overstated the case by reporting in a factual style. Some of the complaints may not be as serious as they seem. To state that authoritative accounting bodies have not specified the primacy of a single method where alternatives exist feeds the notion of a plethora of alternatives. Accusations of absolute disarray in the objectives of financial accounting and reporting are plentiful in the conclusion of the Metcalf Staff Study. There is already much agreement on objectives of financial statements as evidenced by the compilation of APB Statement No. 4, the Report of the Study Group on Objectives of Financial Statements (the Trueblood Report) and in the FASB's Tentative Conclusions.

We agree that no standards can specify all aspects of adequate disclosure. In this regard, the Commission's statement (p. 17) that adequate disclosure will enable the user to understand the events and transactions reported on in financial statements is true.
only in the unattainable abstract. We assume the Commission intended that the user must have an ability to understand(2-7), or no amount of disclosure will do. And there are many other factors, in addition to financial statement disclosures, necessary to permit an able user exerting the necessary effort to obtain an understanding.

As the Commission acknowledges (footnote 14, p. 17), auditors often face demands to show where it is inscribed that a particular accounting method cannot be followed, or alternatively, must be followed. It may not be enough to state that "such demands clearly indicate an inadequate understanding of the scope of generally accepted accounting principles." We suggest that the Commission give more prominence to this in the final report.

In summary, we are concerned that the Commission's overall discussion of generally accepted accounting principles is harsher than is warranted and may lead a reader not otherwise informed to the conclusion of a much greater dearth of principle than actually exists. This should be correctible in the Commission's final report if for no reason other than the FASB's current progress.

Recommendations on Extension of Guidance in Auditing Standards

"Direction in the absence of detailed accounting principles" -- The Commission appears in this subsection to have overstated the authority of Statements of Position issued by the AICPA Accounting Standards Division (AcSEC). Under the present FASB charter, no other body has the authority, enforceable under the AICPA Code of Professional Ethics, to establish accounting principles. Considerable debate occurs both among practicing accountants and between accountants and their clients as to whether the recommendations in an AcSEC Statement of Position must be followed in a particular situation. We are aware of situations of non-uniform application as among accounting firms. This is not to suggest that any firm is acting in an unprofessional manner. We ourselves have not found it advisable to insist on blanket applicability of all AcSEC Statements of Position, because by definition, they do not bear the "force of (FASB) law."

Some industry groups are concerned by the "third tier" standard setting (following after the FASB and the SEC) by the AICPA Accounting Standards Division. There is a need to clarify the AICPA's role in accounting standard setting. We have already recommended in our response to the Metcalf Staff Study that AcSEC adopt a formal policy of exposing for public comment all proposed statements of position, and of permitting qualified representatives of affected industries to attend applicable portions of its meetings.(2-8) Beyond that, it may be appropriate to incorporate more authority for AICPA Accounting Standards Division resolutions through an amendment in the FASB charter or rules of procedure, at least as to matters the FASB does not accept for its own agenda.(2-9)
Reasoning by analogy has been and will always be necessary in the selection of an accounting principle to fit new and unique circumstances. The Commission seems neutral on the propriety of this practice. We recommend establishing a refutable presumption of careful analogy where a specifically promulgated accounting standard does not exist, as opposed to the current practice of selectivity. Procedural guidelines for analogizing would also be helpful.

Likewise, reliance on precedent is useful, but somewhat riskier than rational analogy. There may be circumstantial nuances not known to those wishing to rely on the precedent. Guidelines for precedential reliance should be better articulated. With proper guidance for use of precedent, and a requirement for analogizing, the dilution of accounting principles often attributed to these practices should be minimized.

"Direction for selecting among alternatives" -- To state that the proper selection should result in a presentation "more closely in accord with the substance of a transaction or event" is not sufficiently helpful because of the vagueness of "substance" as we have discussed more fully earlier in this Section. Of course, management and the auditor should document the choice made and the reason for it. The only appropriate manner of doing this is to relate to specified objectives of financial accounting and reporting. To state that management's business judgment and planning should not "supplant" other circumstances is to place a vague additional burden on auditors. (2-10)

We agree the SEC is in error in its requirement that the auditor believe in the preferability of the new method when an accounting change occurs. If "preferability" assessment should be undertaken by auditors, it should apply to all material accounting principles used by an entity whether or not changed. Our agreement with the Report's statement applies to eliminating the SEC's inconsistency; we otherwise have substantial misgivings about preferability as an audit objective.

"Direction for evaluating cumulative effect" -- The Commission recommends that the auditor make an evaluation of the cumulative effect of management's judgment in the presentation of financial statements. We agree that this should be an auditor's responsibility, but only if the additional direction recommended is in fact provided. (2-11)

We recognize that this issue cannot be resolved simply. The FASB needs to provide guidance on cumulative effect assessments even beyond what can be anticipated from its current Conceptual Framework project. And the auditing standard setting body would need to continuously participate so that the resulting guidance is workable. This issue needs prompt attention and, no doubt, resolution in phases.
Elimination of "fairly" from the auditor's report — The summary section (page xviii) of the Report of Tentative Conclusions contains a conclusion relative to Section 2 which does not appear as such in the section text: that "continued emphasis on 'fairness' as a standard is not fruitful — the word 'fairly' should be eliminated from the auditor's report." In a way this conclusion is both fitting and enigmatic. It is fitting in the sense that "fairly" must be eliminated because the current environment would squelch any reasonable definition proffered by the Commission. If implementation of this conclusion is not feasible a less desirable alternative would be an additional standard paragraph in the auditor's report explaining what "fairly" means, and explicitly admonishing the reader that it can not be adjudged to comport with his own biases.

But it is also enigmatic because "evaluating cumulative effect" to avoid "...the overall result (of) a misleading picture..." (p.21), in its unspecified form, is waiting to take the place of "fairly presents."
Footnotes to Section 2

(2-1) While we recognize the Commission's desire to remain reasonably neutral concerning past events relative to auditors' responsibilities, we believe it would have been appropriate to take issue with the citation from District Court decision in the Herzfeld case (footnote 1, p. 13). To allow to stand without challenge the epitaph of "esoteric accounting norms, comprehensible only to the initiate, ... (not presenting) the true financial position to the untutored eye of an ordinary investor," leaves some doubt as to whether the Commission accepts such an unbalanced criticism.

The FASB Broad Conceptual Framework project, along with its Tentative Conclusions on Objectives of Financial Statements, does not attempt to make financial accounting comprehensible "to the untutored eye of an ordinary investor." More realistically, it should communicate with "investors or creditors who have a reasonable understanding of business and economic activities and financial accounting and who are willing to spend the time and effort needed to study financial statements." (Tentative Conclusions on Objectives of Financial Statements of Business Enterprises, p. 3.)

(2-2) This is a variation of the citation attributed to Carl L. Nelson, footnote 3, p. 13.

(2-3) We realize the Commission had to prepare this portion of its tentative recommendations prior to the availability of the Financial Accounting Standards Board Discussion Memorandum on the second phase of the Broad Conceptual Framework project. Certainly we agree with the Commission's recommendation (in footnote 12, p. 16) that the FASB should promptly complete its materiality, conceptual framework and objectives projects. We recommend that considerable use be made of the latest FASB material available at the time of the Commission's final report.

(2-4) With the advent of accounting standards as detailed as FASB Statement No. 13 on leases, or 14 on segmented reporting, it is becoming increasingly difficult for an auditor to locate substantive concept. In the past, APB Opinions beginning with No. 16 contained this statement in the "Notes" appended to each opinion:

"Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered."

Experience with those admonitions has shown that individual auditors have not been able to invoke them consistently or with much frequency.

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(2-5) Reducing alternatives in inventory valuation methods and investment credit accounting will also require the participation of Congress and the Treasury Department.

(2-6) The Accounting Establishment: A Staff Study, op cit., summarizes these complaints on pp. 20-24.

(2-7) See footnote (2-1), second paragraph.

(2-8) Statement of Touche Ross & Co. (for the record of hearings by Subcommittee on Reports, Accounting and Management of the United States Senate Committee on Governmental Affairs) on Accounting and Auditing Practices and Procedures, May 23, 1977, p. 35.

(2-9) At present, the FASB formally acknowledges receipt of a finalized AcSEC SOP. In its usual declining of the matter for inclusion on its agenda, the FASB states (assuming it's true) that the FASB is not aware that the SOP contains any violation of GAAP. (Of course, the FASB is aware of the progress of the SOP before finalization.) This seems an inadequate and cumbersome approach.

(2-10) We have several incidental concerns about this subsection of the Report:

a. Conservatism is described as a general concept. We believe that "conservatism for its own sake may actually introduce bias" (Report of the Study Group on Objectives of Financial Statements, AICPA, 1973, p. 58) and should always be discussed in neutral terms. Its 1970 label as a modifying convention (APB Statement No. 4, paragraph 171) seems superseded.

b. Admonishing the auditor to consider whether accomplishing an objective "other than informing users -- such as reducing or postponing income taxes -- has inappropriately predominated in the choice of accounting principles" suggests there is something inappropriate about lawfully reducing or postponing income taxes. The only real threat seems to be in IRS conformity rules -- de jure (e.g. LIFO) or de facto (e.g. repairs and maintenance). Tax allocation under APB 11 has been an effective guardian.

c. The APB did reach a conclusion as to the proper accounting for the investment tax credit; the alternatives were forced by government.
If the auditor finds that most of the selections or estimates "had the effect of increasing (or decreasing) earnings," this is not necessarily a misleading picture of the entity's earning power or liquidity. As the Commission earlier observed in this Section, substantive compliance is what counts (p. 16). We have already commented on the vagaries of "substance" and "misleadingness."
The Commission's Tentative Conclusions

- "Subject to" and "going-concern" qualifications should be eliminated.
- A separate footnote should be required for uncertainties.

The Need to Clarify the Auditor's Role in Reporting on Uncertainties

The user must assume the function of evaluating the risks a business faces, and the auditor should properly be responsible for evaluating the adequacy of disclosure of those risks. The present requirements for the auditor to express a significant uncertainty in terms of a "subject to" opinion, and in more egregious cases, the need to express a going concern qualification, are inconsistent with the auditor's responsibility for evaluating the adequacy of disclosure of risks.

The auditor is no more able to predict the outcome of many uncertainties than management. Ordinarily, he would be less able, because he does not make the decisions needed to operate the business and cannot assimilate management's planning and intent as though it were his own.

Uncertainties often involve litigation, and one only need look to the debates engaged in between the accounting and legal professions relative to the limited extent to which lawyers will comment on their expectations of ultimate outcome of asserted claims -- or the extremely minor extent of comment proffered on unasserted claims. To grant to lawyers, who by definition know better than auditors what the outcome may be, an understanding of their increasing responsibility for failures in prediction, should be convincing that the auditor certainly lacks of clairvoyance.

Recommendations for Improving Reporting on Uncertainties

Eliminating "subject to" qualifications -- We agree that the audit requirement to express a "subject to" qualification when the financial statements are affected by material uncertainties should be eliminated. We began some research in this area (see summary of the Touche Ross research project on page 176 of the Commission's Report), and the Commission has accurately reported our belief that, although certain conditions relative to qualified opinions could be observed, it would not be possible to ascertain whether the qualified opinion was indeed a self-fulfilling prophecy. Many argue that it is. When the auditor is considering its use, management's concern is understandable.
A separate footnote for uncertainties -- Because an unduly negative inference of the quality of the enterprise is drawn by readers of qualified opinions, and often beyond the gravity of the matter, it would be more beneficial and equitable that the auditor aim toward the appropriateness of disclosure of uncertainties in financial statements. Again, this recommendation must be approached with caution: debates over what constitutes adequate disclosure can be as intense as those relative to whether or not the auditor issues a qualified opinion. For example, in a number of instances in our practice, when concerned about the communicativeness of an uncertainty disclosure in the footnotes -- often as to the gravity of the matter -- we took the opportunity afforded by our qualified opinion to add more specification in the hope that financial statement users would better understand the seriousness of the matter.(3-3)

We think the Commission is heading in the right direction in recommending that financial statements contain a standardized note, similar to that on accounting policies, relative to uncertainties.(3-4) In ascertaining the appropriate content of the note, however, considerable guidance is needed. Deliberate obfuscation could occur through standardization without materiality guidelines for footnote inclusion or exclusion. For example, major issues can be buried in profuse disclosure of miscellaneous litigation; and therefore the auditor must employ some sort of "meaningful communication" filter. Standards for this test are not, to our knowledge, available(3-5) and even the FASB is focusing mostly on what is needed. Materiality standards should work both ways.

The Commission's recommendations for standardized footnote disclosure seem to relate to both specific as well as general material uncertainties directly affecting the reporting company, and not to major uncertainties affecting all business or society. We suggest this be made clearer in the Commission's final report.

In our response to the current FASB Discussion Memorandum on the Conceptual Framework for Accounting and Reporting, we have recommended that a means for depicting the degree of factuality applicable to financial statement measurements and disclosures be developed. There is a scale ranging from the extremes of incontrovertible fact to sheer speculation. We think information measurements and disclosures should be so ordered and described that the user has an opportunity to make his own qualitative assessment of the financial statement balances and net income; presently these are, because of diversity of fact content, substantially "hash totals." And while sheer speculation has no place in financial statements, a considerable amount of management interpretation of uncertainties is clearly to be expected.

The Commission's statement that "no uncertainty for which disclosure is required should be downgraded in importance" (p. 29) is therefore problematic. The user may not be able to distinguish

3.2
which uncertainties are more serious than others, unless they are required to be ordered in a certain way, for example, by groupings. Ranges of possible exposure as discussed in FASB Interpretation 14 of FASB Statement No. 5, (3-6) could be a useful initial step in grouping or sequencing the disclosures.

Eliminating "going concern" qualifications -- The Commission has recommended that the "going concern" qualification also be eliminated as a requirement for the auditor's report, as it is simply an extension of the "subject to" opinion. We agree with this. Liquidation valuations are in conformity with generally accepted accounting standards when liquidation is planned or, even if it is being resisted, when it is highly probable. Planned cessation is not contemplated in "going concern" qualifications, though it may offer numerous disclosable uncertainties about realizable values. Treading near the brink of disaster with no agreed upon yardstick (3-7) to measure its propinquity is an immense problem, however, for both management and the auditor. (3-8)

The Commission points out (p. 30) that "certain simple financial ratios" have been shown by research to be better than a qualified auditor's opinion on a company's future prospects. But the Commission makes no recommendation as to whether any such ratios should be required to be published, or whether auditing procedures should necessarily include the computation of those ratios. We believe standardized analytical ratios should be required in financial statement presentations. A working capital ratio, earnings per share and net assets per share, for example, are commonplace ratios taken for granted. More is needed. (3-9) The auditor should, of course, be satisfied as to ratio computation accuracy and context of presentation. The auditor should also utilize those financial analysis techniques which would indicate long-term as well as current liquidity as a means of improving prediction of insolvencies. (3-10)

In summary, the auditor should be responsible for providing protection against "information risk" -- that there is adequate disclosure presented by management of the potential effect of uncertainties on the prospective earnings and financial position of the enterprise. He should not have to make the user's assessment of when risk becomes too risky.
Footnotes to Section 3

(3-1) We think the Commission gives an incorrect inference by using the Herzfeld decision as an example (on p. 27) of an unheeded uncertainty qualification. The Commission's statement in Section 1 that court decisions "...must be considered carefully because a decision is usually closely related to the facts of a particular case" seems especially applicable here. If the court had not questioned the substance of the transaction, we speculate that the opinion qualification might have been sustained.

(3-2) See Statement on Auditing Standards No. 12, "Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments."

(3-3) It could be argued that, since the auditor's report is viewed as a symbol, even the phrasing of the qualification is passed over lightly and therefore should not substitute for even an iota of footnote disclosure by management. The Commission's recommendation to eliminate qualified opinions would focus attention where it belongs -- on management disclosure.

(3-4) This recommendation would have to be adopted by the Financial Accounting Standards Board, who should be requested to accelerate consideration; otherwise this will come in a later phase of the Conceptual Framework dealing with financial statement presentation.

(3-5) Existing professional pronouncements are a "one way street." For example, paragraph 430.03 of SAS No. 1 admonishes that "Verbosity should not be mistaken for adequate disclosure." The paragraph goes on, however, to deal with required disclosure, and says nothing of gratuitous material. Likewise, Statement of Financial Accounting Standards No. 5 prescribes disclosure of material uncertainties but avoids proscribing of clutter. Many times the genuine limiting factor is the amount of annual report space allotted to the financial statements.


(3-7) The SEC's ASR 115 precludes securities registration where there is an imminent threat of liquidation. This condition is not defined, but we (and others) have adopted "one year" as the minimum period of imminence during which adequate financing must be reasonably predictable. As with most proprietary standards, we are often challenged about its arbitrariness and enforcement without "due process."

3.4
Statement on Auditing Standards No. 2, paragraph 25, is an indicator of auditor schizophrenia. It says (in part):

"In cases involving uncertainties, the auditor should be able to form an opinion whether the financial statement items affected have been stated in conformity with generally accepted accounting principles in all respects other than those contingent on the outcome of the uncertainties. If he is satisfied that they have been so stated, he may appropriately express an opinion qualified by reason of the uncertainties."

But footnote 8 (perhaps an insert for garnering sufficient votes) says:

"The Committee believes that the explanation of the uncertainties and the qualification of the auditor's opinion contemplated by this Statement should serve adequately to inform the users of the financial statements. Nothing in this Statement, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner, and the auditor's report should give all the substantive reasons for his disclaimer of opinion."

Industry groups and rating services already publish a wide variety of ratios to assist in comparisons among companies. Agreement on which are most useful in general purpose financial statements is needed. Auditor association would enhance their credibility and indirectly improve the intercompany comparisons.

Two examples of liquidity predictors in audit use today in our firm's "FINALY" (Financial Analysis) time sharing program are:


- "A Discriminate Analysis for Predicting Bankruptcy" (Edward Altman and Thomas P. McGough in Journal of Accountancy, December 1974, pp. 50-57)

3.5
SECTION 4
CLARIFYING RESPONSIBILITY FOR THE DETECTION OF FRAUD

The Commission's Tentative Conclusions

- The auditor "has a duty to search for fraud and should be expected to detect those frauds that the exercise of professional skill and care would normally uncover."
- Auditors should "establish an effective client investigation program."
- Auditors should "take immediate steps if evidence shows that management is untrustworthy."
- Auditors should "observe conditions suggesting predisposition to management frauds."
- Auditors should "maintain an understanding of a client's business and industry."
- Auditors should "extend the study and evaluation of internal control."
- The AICPA should "develop and disseminate information on frauds and methods of detecting fraud."
- The AICPA and auditors should "be aware of possible deficiencies in individual audit techniques and steps."
- Auditors and clients should "understand the limitations of incomplete audits."

The Expectations of Users

The Commission notes (p. 31): "In the last ten years, a number of major frauds that independent auditors failed to detect have focused unfavorable attention on this aspect of the audit function."(4-1) The Report also distinguishes between management
fraud and non-management fraud but does not seem to directly addressess another way of classifying fraud — defalcations, or those acts committed by employees as well as management to convert cash or other assets directly to their own benefit (which acts should be guarded against by the system of internal controls), and acts committed by management designed to misrepresent the company's financial position and results of operations in the financial statements, most often intended to produce indirect benefit to the perpetrators. This distinction is very significant; misrepresentations are much more difficult to deter and detect through the operation of internal control systems, as so much is dependent on management's intention and veracity. The implications become significant when assessing the nature of assurance truly to be provided by an auditor's attestation concerning internal control weaknesses and efficacy of illegal act controls (both discussed later herein).

Fraud of any type represents a loss to the shareholders of a company and to the extent controls reduce the losses from fraud by an amount exceeding their cost, such control measures should be implemented. Clearly, the independent audit is a potentially effective control mechanism concerning fraud.

Touche Ross believes fraud detection is an extremely important subject.(4-2) Both users and auditors are confused about it and clarification is necessary. However, as explained below, we believe the position the Commission has presented needs further study.

The Commission's Suggested Explanation of the Auditor's Responsibility for the Detection of Frauds

"A duty to search for fraud" — The Commission states (p. 36) that the auditor has a duty to search for fraud (with which we agree) and he should be expected to detect those frauds that the exercise of professional skill and care would normally uncover. This specification says nothing of materiality although it follows a statement about the need to design audits to provide reasonable assurance(4-3) that the financial statements are not affected by material fraud.

We believe the Commission should be unequivocal in delimiting the auditor's reasonable assurance to the detection of frauds which would have a material effect on the financial statements. Otherwise, minor peculations could be asserted to fall within the auditor's scope, which he would have to extend to be sure he found them. In essence, the application of "normal professional skill and care" would continue to mean whatever the courts adjudicate it to mean.

The Commission might have meant a materiality modifier in its suggested requirement, as "normal skill and care" could be argued to include it. But we feel it was omitted intentionally
because of the Commission's recommendations on studying controls (see p. 4-7 herein). Because of the importance of materiality as a parameter for the auditor's responsibility to search for fraud, we offer the following comments and recommend their assimilation into the Commission's final report:

- **Materiality** -- The designation of "materiality" as a criterion for responsibility is essential to avoid confusion. Further, this requires that users (and auditors) must know what "material" means. The Commission recognizes (footnote 12, Section 2) the importance of the FASB completing its study on materiality; this cannot be overemphasized. However, the FASB's effort deals with materiality from an accounting view (that an amount is material to the financial statements). The Commission should also discuss materiality from an auditing view as it is equally important and may not be receiving adequate consideration. Auditing materiality relates to the extent of tests considered necessary by auditors to obtain reasonable assurance that material errors or irregularities do not exist. This aspect of materiality has a direct effect, for example, on the number of items examined in various tests.

- **Material Fraud** -- The independent auditor's program of examination should be designed and executed to provide reasonable assurance that fraud (regardless of whether committed by management or non-management employees) having a material effect on the financial statements does not exist or has been detected.

  The auditor's efforts would include a review and evaluation of internal controls to isolate areas where material fraud is a possibility, and the performance of substantive tests of balances and transactions which would provide a reasonable probability of uncovering material effects if they exist.

- **Non-Material Fraud** -- Fraud which is not material is not desirable from any point of view. However, since its existence should not cause losses from reliance on the financial statements, its consequences are significantly different than those of material fraud. Touche Ross believes that an approach which raises the level of audit effort on all audits to a point which would ascertain the existence of non-material fraud, is inappropriate. However, if the directors and management believe additional effort by independent auditors to be a cost-beneficial approach to controlling non-material fraud, they should be engaged -- apart from the regular audit -- for such purpose.
Limitation on Discovery -- In those cases where the auditor's tests utilize appropriate available procedures, are applied to a reasonable number of items where samples are used, and are carried out diligently and thoroughly, his responsibilities should be considered fulfilled. Nevertheless, failure to detect material fraud in these circumstances could occur (1) because audit evidence is effectively altered or suppressed, e.g., through forgery or collusion, so that no reasonable audit procedures could expose the fraud, or (2) because the use of sampling caused the necessary evidence not to have been selected.

As to forgery, the auditor does not presently have, and should not be expected to have in the future, an obligation to verify the authenticity of documents in the absence of justified suspicions. And skillful collusion will not be detected by the use of procedures now used or to become available to auditors. (4-4)

Sampling risk (i.e., not selecting the faulty items for examination) is attendant to cost-effective auditing, especially when viewed for society as a whole. The proper application of statistical sampling should be allowed as an effective defense; but the auditor must still answer for the appropriateness of his pre-sampling assessment of the degree of error or fraud possibilities. (4-5)

Recommendations on a Standard of Care for Fraud Detection

"Effective client investigation program" -- The Commission states (on p. 37): "A systematic approach to investigating a prospective client before accepting a new engagement, and a periodic review of continuing engagements are essential tools of independent auditors. We support the view expressed in SAS No. 4, "Quality Control Considerations for a Firm of Independent Auditors," that an auditor has no duty other than to himself with respect to the acceptance, rejection or retention of clients. We believe we have been among the first to formally adopt detailed standards and requirements for the screening of new clients as well as for reassessment of existing clients. Of course, our policies come down to the same conclusion as the Commission does: should the auditor have good reason to doubt the integrity of a prospective client's management, he should decline the engagement. There are difficult decisions to be made, and therefore some latitude in judgment must be expected.

There is another school of thought that holds that "almost anything" is auditable in that the auditor may employ all the procedures he deems appropriate, and if he finds that there are needed procedures he cannot employ (e.g., because of an inability
to satisfy himself about management's intentions or about completeness of information), he always has the vehicle of his report to make those scope limitations known.

The proper approach has to lie somewhere in between -- a reasonable latitude for the auditor to accept new clients, along with an expectation that extraordinary audit procedures may sometimes be preplanned for a new client.

We believe that the Auditing Standards Board should articulate criteria for new client acceptance.(4-6) If, in fact, such standards could be challenged because of discrimination, it would be better to know that rather than to have each individual auditor set his own rules on sensitive issues. Naturally, each audit firm would have to employ detailed approaches consistent with its own internal operating philosophies. For example, it may be appropriate to reject a prospective client not because of any reason relative to the client, but because the audit firm does not have expertise in the client's specialized industry, and it would not be economical to devote the time and expense necessary to obtaining a proper level of expertise.

Prior to the advent of SAS No. 4, little attention was given to the need for the auditor to formally address the question of client retention. We have had such a concept in practice for many years, but only invoked it when something occurred to raise a question about the continued relationship with a client. However, in 1975, we adopted, on an experimental basis, an annual review by engagement management under the title of "Client Profile and Audit Scope" (CPAS form). We require that this profile be completed for every publicly-held client and it is optionally applied to others. This form represents a detailed review of client characteristics for purposes of assessing retention and assisting in the annual challenge of the scope of the engagement.

Our profile gathers information with respect to nature of the business, the assigned engagement personnel, and summary financial data of the client. Background on the client is included which indicates the key management personnel, reasons for changes in management personnel, profile of the board of directors, and identity of individuals with whom the client is associated. The engagement partner must himself complete certain sections of the form and make an overall evaluation of the propriety of retaining the client.

Public accounting firms render a quality service to society and to their clients, and should be dedicated to retaining the value of their firm names in the business community and with the general public. We believe that every auditing firm must develop effective new client investigation and client retention procedures to ensure that the services of the profession are rendered to clients with integrity and credibility.
We are now in the process of incorporating the experimental CPAS form into the regular auditing standards of our firm. We think our experiment was successful, as it did identify a few situations requiring close scrutiny. But most important, it gave us the assurance that our audit scope was properly tailored to particular client attributes.

"Untrustworthy management..." — The Report of Tentative Conclusions states (p. 38): "Doubts about management integrity cannot be 'satisfactorily resolved' merely by the extension of normal audit tests." And, "...the auditor should consider abandoning his attempt to audit; that is, he should consider resignation or other appropriate responses." The Commission goes on to state that the only way a resolution of doubts can occur, is for the auditor to satisfy himself that the doubts were unfounded. It seems unrealistic to state this so categorically: "doubts" should not be dealt with as if they were always facts to be proved or disproved.

While we would agree that a resolved doubt is one that is unfounded, there should also be room to adjust audit scope relative to "less-strongly-held" doubts -- not as a means of proving there was no substance to the doubts -- but simply to assure by appropriate audit procedures that whatever the possible inimical effect of the doubt on proper financial reporting could be, it is not likely to occur. As an example, a doubt about a client's representation of no "relationship" with a major customer may not be disprovable, but the auditor can establish many procedures to audit for this factor.(4-7)

"Predisposition to management frauds" — The Commission recommends (on p. 38): "In planning and conducting his examination, the auditor should take into account unusual circumstances or relationships that may predispose management to commit frauds." As this recommendation seems already called for by SAS Nos. 6 and 16, we think that should be acknowledged in the Commission's final report. If an extension of existing standards is contemplated, that should be made clear and the standards should be explicated.

"Understanding of a client's business and industry" — We agree that a prerequisite for performing a satisfactory audit is a knowledge of the client's business and peculiarities of the industries in which it operates. This Commission recommendation is within the subsection "...on a Standard of Care for Fraud Detection," but it is not clear what special knowledge of industry practices specifically contributes to fraud detection.
Within industry groups, there are wide differences from company to company and these are as important to understand as "industry peculiarities" in performing all phases of a satisfactory audit. For example, many companies may have business segments in more than one industry. (4-8)

A greater depth of knowledge of industry peculiarities is probably needed in auditing overall, and not only for fraud detection. Accordingly, we believe that the focus should be on requiring the auditor to understand the economic factors underlying the particular business, given the products and services it provides and the markets in which it operates. Sharing industry characteristics with many other independent entities may simply facilitate the previously experienced auditor's understanding of the business.

Overall, the Commission's recommendation as an objective in every audit makes sense. To make it more helpful and to place it in the proper perspective, we suggest the last paragraph (4-9) of this subsection be rewritten to de-emphasize the industry slant, as follows:

Knowledge of substantial financial or business-related risks deliberately or unwittingly accepted by the company under examination is important to the auditor. Such risks can represent instability in the company's financial position. Thus, related audit areas may be more sensitive and require extended procedures to properly evaluate them; and there may be significant uncertainties requiring disclosure.

Though all of the steps required to understand the company's business in the conduct of a satisfactory audit are also necessary in determining substantial financial or business-related risks, the Commission believes additional steps are required as well. Presently, the profession has not, to any significant extent, defined such risks and appropriate methods of revealing them. Definition should be undertaken on a formal basis as soon as possible and incorporated in generally accepted auditing standards.

"Extend the study and evaluation of internal control" -- The Commission states (p. 39) that: "The auditor should be concerned with all controls that have a significant bearing on the prevention and detection of fraud." Because fraud is fluid, there is no way to create the "ultimate" prevention controls particularly if collusion is involved. The present requirement that the auditor study existing systems of internal control to determine the extent of reliance thereon in the setting of audit scope is, in our opinion, the proper standard which should not be disturbed. SAS No. 16, which requires that an audit be planned and carried out in such a way as to provide reasonable assurance that financial statements are not materially affected by errors or irregularities, does not
specify a single approach. We think that the auditor should not assume responsibility for all systems, when there can be no assurance that "perfection" in those systems will prevent material fraud.

It is an incorrect assumption, if made by the Commission, that the auditor already studies and evaluates "all controls, at least in publicly-held companies, that have a significant bearing on the prevention and detection of fraud." He will study a description of controls in areas having the potential to materially affect the financial statements, but he will not necessarily perform tests of compliance (we think this is what the Commission means by "evaluation") in all those areas. Often he will choose a mostly substantive (year-end verification) approach.

The Commission may be recommending a substantial addition to the cost of auditing without commensurate benefit, as well as suggesting to those who rely on auditors' services that a substantially greater protection will be given against material fraud. We believe the present standards are adequate, and we urge the Commission to reconsider this recommendation.

"Disseminate information on frauds" — We wholeheartedly agree, subject to protecting the rights of those who may be accused but not adjudged guilty, that "methods and procedures should be adopted for public accounting firms to exchange information on developments in the perpetration and detection of fraud. The AICPA should establish means for regular dissemination of that type of information."

A wider distribution of the perpetration details in previous material frauds will, at least, confine other potential perpetrators into narrower, untried avenues; and such publicity by itself might make new fraud opportunities more easily detectable.

The report on Equity Funding is a good example of the kind of analysis suggested by the Commission. However, considerable effort was required to produce that report, and if this level of effort is needed every time fraud information is to be disseminated, knowledgeable practitioners will have insufficient time to contribute. Therefore, perhaps the method to be used should be more factual and mechanical, than evaluative. Evaluations should be left to the courts.

We believe the AICPA is the appropriate vehicle for the dissemination of this material. A standing committee could be charged with responsibility for this function, although it could just as easily be made a part of the Auditing Standards Board, such as a subcommittee thereof. In this manner, the possible need for improvements in auditing standards could be more timely observed.

"Effectiveness of conventional auditing techniques" — The Commission asks (p. 40) that "constant attention should be given ...to the effectiveness of conventional auditing techniques and to
the development of new ones." This is an appropriate recommendation and should probably be repeated in (or moved to) Section 10.(4-10)
Most of the research efforts have been related to financial accounting and reporting in recent years with little research and guidance on auditing methods.

"Limitations of incomplete audits" — It is exceedingly important that a client understand the limitations on an auditor's engagement whether it be a normal audit engagement or one of the seemingly limitless special engagements for internal purposes. The greatest difficulty auditors have is communicating the extent of their responsibility, and this is especially evident in areas where the auditors are or may be in a position to issue a report other than the standard audit report for general public use (for example, reports on internal control and on limited reviews of interim financial information). To assure a minimum of misunderstanding, limitations should be required to be stated in the auditor's formal report.

The Commission's acknowledgement (on p. 40) that there are "inherent limitations" in "undertaking special engagements that contain an element of fraud detection" does not resolve the fundamental problem of a lack of specificity as to what the auditor ought to accomplish by the employment of a given procedure. Although finality can never be achieved in these matters, a great deal more attention needs to be paid to procedural "cause and effect" relationships. Most auditors will devise valid procedures if the objective is attainable and clearly stated. Having done that, the auditor should not have immense difficulty in communicating (even if lengthily) such information to a knowledgeable user of his report.
(4-1) An abundance of this "unfavorable attention" is found in the Metcalf Staff Study. Our firm's views on fraud detection, in response to the Staff Study, are contained in Appendix A, page 1.

(4-2) We are certainly aware of the gravity of management fraud, as we have suffered the U.S. Financial fraud (ASR 153) and have implemented (see page 11.6 herein, concerning "defensive auditing") considerable procedures aimed at preventing a recurrence.

The Commission mentions ASR 153 on pages 32 and 33. On page 32 the SEC homily in ASR 19 (1940) on McKesson & Robbins, Inc. is identified as "reiterated in 1974 in exactly the same terms in ASR No. 153." It was not reiterated, but was cited, in ASR 153. In any event the comparison seems inappropriate in the context of the Commission's Report. It is our position that the deceptions in U.S. Financial were far more complex than those involved in McKesson & Robbins, although relative to the state of the auditing art at each of the respective dates we would agree that the detection was beyond what was expected of and normally practiced by auditors until in each instance spoken on by the SEC. And on page 33, the Commission indicates that transactions between U.S. Financial and related parties, with management not adequately disclosing the nature of the related parties or their existence, gave the appearance of income realization when in fact it did not occur. The inadequate disclosure should have been emphasized as victimizing both the financial statement users as well as the auditors. We maintain, and ASR No. 153 agreed, that considerable information was withheld from us, and therefore it could not be "adequately disclosed" in the financial statements, much less employed by us in the evaluation of the appropriateness of accounting principles applied.

A further feature in the U.S. Financial case was the inability of existing accounting principles to fit the "new kinds" of transactions developed by U.S. Financial. Auditors still face this problem in other areas currently, for example in the maneuverings to structure new transaction forms having a desired result because of or despite FASB Statement No. 13. (Refer to footnote 2-4.)

(4-3) Reasonable assurance for material asset "accountability" is also here ascribed to audit design. We have discussed the need for a definition of "accountability" in Section 1.

Statistical sampling results are easily quantifiable, but measuring the risk of error or fraud needs much more research.

Touche Ross & Co. has developed extensive, yet balanced, procedures for new client investigations, and we synopsize them here in the event the Commission wishes to be more specific in its final report. Our procedures, which are more intensive for publicly-held companies, include obtaining and evaluating a list of key officers, directors and principal stockholders; talking with key personnel reviewing recent financial statements; talking with mutual acquaintances, such as bankers and attorneys; discussing with the prior accounting firm the reason for termination and possible reasons why we should not accept the engagement; and preliminarily evaluating the conditions of records, the accounting system and the financial personnel. In addition, we may obtain a business information report on the company, its key management personnel, directors and controlling shareholders.

We require that our extensive new client investigation procedures be documented. All unfavorable answers to our new client questionnaire must be fully explained and explicit rationale given as to our position with respect to the matter and how it will affect the scope of our audit.

We recognize that certain companies are not good business risks for our firm and engagements with them should be refused. These include companies with an unsavory reputation (such as prior criminal conviction) of officers or directors, use of unacceptable accounting principles, extremely weak financial condition of the company, or situations where the proposed client was previously a client that discharged us under unfriendly circumstances. Accordingly, our policies require that in accepting any new client in the firm's accounting and auditing functional area, we must make a fundamental and thorough evaluation of the proposed client.

We have suggested a number of procedures in our Technical Letter No. 149 on "Management Involvement in Material Transactions." None of the procedures are guaranteed to prove the point, but they will cause penetration to a considerably greater extent that if they were not applied. Note that SAS No. 6 on "Related Party Transactions" is also more advisory than prescriptive when it comes to specialized auditing procedures.
Attempts to establish explicit standards for industry competence would require resolving a fundamental question — what is an industry? This is more difficult than it might appear. In some industries there are close similarities, for example, commercial banks, mutual savings and loan associations, and life insurance companies. However, especially outside of the financial services area, industry categorization can become extremely difficult. For example, is manufacturing an industry? A brief review of the SIC codes within manufacturing will demonstrate how difficult classification can be. Companies subjected to comprehensive government regulation tend to be more easily classifiable.

What this all points out is that although industry knowledge, in a general way, is important to understanding a business, other factors such as size and diversity of the operations are at least as important.

The Commission has overstated its point by asking the auditor to "make every effort to acquire all readily available knowledge that might lead to the perception of substantial financial or business related risks..." (emphasis added). We are not aware of what "readily available" means in the final analysis, and some reasonable limit should be set.

Care should be taken to avoid the inference, however, that the "proper" combination of auditing procedures will invariably "provide complete assurance of validity."
The Commission's Tentative Conclusions

- There is a need for clear specification of illegal or questionable acts.
- Corporate statements of policy and monitoring thereof are needed.
- Auditors should detect those illegal or questionable acts that the exercise of professional skill and care would normally uncover.
- Adequate consideration to a detected illegal or questionable act must be given at the appropriate level of authority.
- Auditors should review management's guidelines, policies and monitoring procedures, to evaluate whether they contain material weaknesses.
- Management should include in the annual report a statement of policy on illegal or questionable acts and that procedures have been implemented to monitor compliance.
- Legal counsel should have increased involvement.

An Evolving Public Concern

We cannot help but observe that the title of this Section contains the word "accountability." We earlier discussed (p. 1.2 and footnote 1-2) the need for a uniform description. At that juncture the emphasis was on financial statements being useful in demonstrating management's "accountability." Here in Section 5, by linking "corporate accountability" with law, the proposition can be made that law-accountability is therefore to be served by the financial statements. As explained in our remarks which follow, we
think this is a proper direction to explore, but we are concerned that present financial accounting and reporting are not ready for the burden. Auditors are not lawyers, though they may be expected to have some knowledge of legal concepts, certainly not in a depth sufficient to identify and assess or adjudge illegality without advice of (or reliance on) counsel competent in the particular issues. So called questionable acts (these include acts not provably illegal and acts, while legal, which are offensive to the public's moral tenor -- all as interpreted by the public constituents' elected representatives in Congress and appointed governmental regulatory agents) are even more elusive of identification -- both to auditors and lawyers.

In our remarks which follow we agree in principle with most of what the Commission recommends, but with these general qualifications:

1. Materiality for purposes of financial reporting should not be uniformly established at a level so quantitatively or qualitatively low that, in addition to capturing all detected illegal and questionable acts as they are to be defined, profuse other detail is swept in, possibly making financial reporting unintelligible.

2. The Commission's acceptance of reportability within financial statements of detected illegal or questionable acts might be somewhat premature. The public clamor for auditor guardianship, of itself, is not in our view a proper reason for adoption of disclosure requirements. Yet the SEC has not generally felt financial statement inclusion needed -- though disclosure in SEC filings outside of financial statements has been the SEC's reasoned remedy. Only where the enterprise and its auditor have assessed that effects of the events have a reasonable probability of materially affecting the financial statements has financial statement and (sometimes) auditor report inclusion been deemed necessary.

3. Focusing by the Commission on illegal or questionable payments, but not on civil rights or other social accounting topics, along with the fact that this Section is virtually the only one in the Report of Tentative Conclusions not having been debated for years by auditors, seems to underscore the contemporary nature of the subject. Once added to the auditor's responsibilities, it will not likely be removed, though its importance may diminish by the advent of later "public" concerns. A future cause celebre, for example, might be energy efficiency.

4. In general, we are in favor of publicly-held corporations adopting codes of conduct with respect to illegal and questionable acts. Surely such codes are useful to prevent misunderstanding by officers or employees, but we think
that most instances that are forbidden by such codes are already well-known to employees ("ignorantia juris neminem excusat"). Thus, monitoring becomes the critical factor, and cleverly designed approaches to avoid "being caught" in violation of corporate standards may nonetheless evade detection by even the most penetrating of audit techniques.

It has often been alleged that auditors should have an additional "sense" permitting them to perceive the existence of a missing ingredient where others would fail. While the auditor should use logic in piecing together all of the information coming to his attention, he is not clairvoyant as the Commission admits, and the Commission carefully avoids overemphasizing what will be achieved by codes of conduct and compliance auditing.

5. The Commission should prepare to identify how future topical matters become incorporated in the auditor's function and how matters no longer topical are eliminated or relegated to others.

6. The Commission's recommendation for the establishment of a proper auditor's role in the area of illegal or questionable acts has to be given very cautious regard, simply because of the electrified atmosphere created by disclosures of such acts.

7. Law is practiced by lawyers, geology by geologists, property valuations by appraisers, and on and on. We must be extremely careful not to assume every responsibility no one else wants.(5-3)

In the subsection on "Confusion Over the Auditor's Responsibilities..."(5-4) the Commission remarks (on p. 44) that the guidance provided by SAS No. 17 is not enough. We agree. In particular it was expanded to cover "illegal acts" when it should have dealt with "illegal payments" which are more closely related to financial statements,(5-5) and therefore could have been more incisively dealt with.

Further, the action expected by the auditor under SAS No. 17 in obtaining assurance of "appropriate consideration" as to detected illegal acts even though immaterial, such as withdrawing from the engagement, is a commendable idea in concept but lacks specificity -- thereby making such a requirement dangerous when later challenges arise. Given the short duration between releasing SAS No. 17 and the issuance of the Commission's Report, however, the opportunity to improve on SAS No. 17 is timely.
In the subsection on "Limitations on the Auditor's Ability to Deal with Legal Matters," the Commission notes that auditors "...are not lawyers nor are they criminal investigators, and they do not presently possess the training or skills of either group" (emphasis added). We are concerned about what the Commission has in mind for the future. If the auditor is, over a period of time, to assimilate other disciplines having a bearing on social accountability (the Commission's thrust in Section 1) there is no discipline or expertise which may escape the auditor's comprehension. Rather than overemphasize what will be achieved by codes of conduct and compliance auditing, we suggest that there be a concerted effort to involve legal counsel to the fullest extent of their expertise.

A Framework for Auditor Participation to Help Achieve Corporate Legal Accountability

"Specification of illegal or questionable acts." — We agree wholeheartedly with the Commission's recommendation that a clear specification of illegal or questionable acts is an essential prerequisite to assure the reasonable success of any program to obtain disclosure of client's questionable and illegal acts. However, the Commission's point needs to be expanded. Specification of illegality and questionability can be meaningful only in the context of the intended usefulness of the information.

For instance, if the principal concern is to assure that adequate disclosure is made to investors and creditors, there should be postulated what their interest is, and why. Parking violations by officers would not be included, as some measure of magnitude would be adopted. In many cases, the amounts paid would probably be immaterial in relation to the financial statements, but legal actions which could follow from public disclosure of the problems might be material. We believe that reasonably workable standards could be developed for identifying illegal acts which might have to be disclosed and financial measures for determining whether they should be disclosed.

Questionable acts (those legal acts thought to be unethical or to possibly be illegal), on the other hand, need to be defined much more specifically. There are presently no objective criteria for questionable acts, as there are for illegal acts upon adjudication. Legality can be evaluated by comparison of the activities at hand with the law (regulatory, legislative, and judicial), but there is no comparable basis for establishing questionability.

In any event, it is most important that criteria be developed for distinguishing, from among all the questionable and illegal acts which could occur, those which would require disclosure. Otherwise, economical means for disclosure cannot be devised, as managements will not be able to systematize the gathering of information. The high cost of meticulous scrutiny of
many different areas for illegal or questionable items through special investigative efforts can be minimized only where a systematic approach is used. Cost savings which can flow from systemization can be felt at several levels:

1. Managements can operate by exception rather than by personal investigation;

2. Those charged with detection (under the Commission's proposal, internal auditors, independent auditors, and lawyers) could test systems and rely on existent controls as a means of restricting investigative scope; and

3. The disruption to normal activities created by management's attention to nonproductive activities would be reduced.

SAS 17 interprets generally accepted auditing standards to require auditors to be alert for illegal acts needing disclosure in a client's financial statements and recognizes that other nondisclosable illegal acts may also be discussed. The SAS also avers that detection of illegal acts is not the primary purpose of an audit and thus some may go undetected, simply because of limitations inherent in auditing techniques. It will be essential that the specification of illegal or questionable acts and their disclosure criteria be balanced with the requirements of generally accepted accounting principles. To specify relatively inconsequential threshold limits for disclosure of illegal or questionable acts within the framework of generally accepted accounting principles could eventually bring down other accounting materiality limits, and possibly result in an immense increase in society's cost for auditing.

Careful consideration should be given to where and how questionable and illegal matters not material in relationship to the financial statements should be disclosed, if in fact they should be disclosed.

Another key issue is to identify who is to decide the specific disclosure criteria for illegal and questionable acts. We believe this responsibility should lie with regulatory agencies and should be based on specific enabling legislation. The objectives of having disclosure of illegal and questionable acts should be set by Congress which should also parcel out enforcement authority to appropriate regulatory bodies. The Financial Accounting Standards Board should then delineate criteria for reporting of illegal and possibly of questionable acts in financial statements.

"Necessary corporate actions" -- The Report of Tentative Conclusions states (p. 46) that "Corporations must also adopt procedures to provide for effective monitoring of compliance. To the extent that independent auditors are to be involved in monitoring compliance with such policies there must be an understanding and identification of the parts of the policy statement that can be audited."

5.5
The Commission correctly concludes that developing means of monitoring corporate accountability ought to accrue to the corporations themselves, and that not all aspects of corporate codes of conduct would be susceptible of effective compliance monitoring by auditors. Auditors can be helpful in designing audit techniques applicable to companies' policy statements. Where the aim is to test compliance with a client's code of conduct, auditors can do so reasonably efficiently for most provisions. But auditors cannot be expected to provide assurance as to inherent effectiveness of conduct codes to satisfy imprecisely stated societal goals. Thus it should be stated that auditors should not be expected to monitor compliance with an unspecified general standard far more vigorous than many corporations could realistically adopt as policy statements. The auditor's expertise should lie in evaluating the probable effectiveness of certain of the company's controls intended to assure compliance with its stated conduct code.

Nonetheless, certain elements are becoming tacitly understood to be essential ingredients of corporate conduct codes. For instance, one could hardly argue that codes of conduct should not prohibit the making of illegal political contributions or bribery of officials of foreign governments.

The problems are that not all clients have codes of conduct, not all codes of conduct are the same, and the objectives that the codes of conduct should achieve have not been specified anywhere. Thus, the effectiveness of the use of independent auditors in monitoring compliance with corporate codes of conduct cannot be expected to surpass the inherent effectiveness of the codes themselves.

In order to assure that corporate codes adopted by companies meet satisfactory standards, such standards, including materiality specification, will have to be developed and disclosure of deviations from those standards (i.e., detected noncompliance) should be required by law or regulation.

"Conduct Code Considerations" -- The problem the Commission and the profession are grappling with will not be resolved through the single dimension approach of requiring policy statements. In fact, overemphasis of the value of policy statements could hamper the development by companies of a more comprehensive approach to near-elimination of the future occurrence of illegal payments. We considered this factor in designing our firm's approach to assessing the risk of illegal or questionable payments being made and in considering the nature of controls or policies that might prevent or delimit them. Many factors other than codes are involved.

The general framework of controls and policy developed by us in the area are the following:

"Internal control features supplementing the usual accounting controls which may normally be considered
to minimize the likelihood of illegal payments are considered in the following sections.

General

1. Existence of a policy(5-8) requiring compliance with all laws and regulations which apply to the company.

2. A requirement that all significant contractual arrangements which entail an obligation on the part of the company be written and/or approved by counsel.

3. A requirement that all material transactions in which management is involved be specifically approved by the board of directors.

4. Existence of outside counsel or a reasonably autonomous legal department charged with the responsibility to determine and monitor compliance with laws and regulations to which the company is subject.

5. Existence of a formal conflict of interest policy which is adequately policed.

6. Existence of an appropriate policy (and administrative controls designed to demonstrate compliance with the policy) requiring an investigation of the business reputation of persons having the authority to represent the company, with the extent of the investigation commensurate with the authority of the representative. The policy would usually apply to consultants and agents, but should also encompass employees.

Currency Transactions

1. Transactions in currency except for petty cash, payroll, and other normal business transactions always paid in cash should be prohibited except where a specific need is clearly demonstrated, documented and approved at an appropriate level.

2. A strict accounting should be kept of all corporate currency funds and transactions. The currency for each transaction other than petty cash, payroll or other normal business transaction always paid in cash should be provided by cashing a check specifically drawn for that purpose.

3. Adequate review by internal audit.

Soft Expenses

1. Invoices submitted to the company for payment of soft expenses should detail the service rendered, including, as appropriate, hours worked, billing rates, etc.
2. Formal written contracts should exist for all agency arrangements which include provisions which prohibit the agent from acting illegally in the corporation's behalf and which require a strict accounting for all corporate funds over which the agent has custody.

3. The company should provide an engagement letter to or receive a proposal letter from all professional firms and consultants describing in detail the services to be provided.

4. Regular written reports should be forthcoming from agents and consultants in conjunction with significant long-term projects, and the significant content of project-related meetings and phone contacts should be documented in file memoranda.

Management Compensation

1. Existence of formal undertakings by management personnel to comply with corporate policies and applicable laws and regulations when acting on behalf of the corporation, and also perhaps contracts indicating the amount of compensation or the manner in which it is to be determined.

2. Non-standard management bonuses and special compensation arrangements should be specifically approved by the board of directors."

We think that if the Commission emphasized a spectrum of controls as the corporate requirement, this would have the added benefit of inculcating in management and the board of directors their primary responsibility to prevent or delimit illegal payments. Whatever formal and publicized conduct code follows from that is, then, the product of doing the basic work, and not the object in itself.

"Exercise of professional skill and care" as a standard for uncovering illegal or questionable acts; adequate consideration of detected illegal acts and auditor's review of company policies and procedures --

In discussing "Recommendations of the independent auditor's responsibilities (p. 46)," the Commission states: "In the course of an audit, ... the independent auditor should be expected to detect those illegal or questionable acts that the exercise of professional skill and care would normally uncover. Additional guidance is necessary on the meaning of the appropriate exercise of professional
skill and care in this area. Important elements would include guidance on the evaluation of areas of risk and exposure to illegal acts, recognition of warning signs of the existence of such acts, and development of audit procedures applicable to those circumstances."

We agree that additional guidance to that already contained in SAS No. 17, "Illegal Acts by Clients," is needed. We have studied the issue and have advised our firm's auditors (5-9) to consider the following matters for each of the identified items:

1. Recognition of warning signs of such acts

In addition to the matters included in SAS No. 17 that may raise questions about the possible existence of illegal acts, when auditing material transactions, also consider the following:

- Examine large currency (as opposed to check) transactions as they are not as easily controllable or auditable as check transactions. Further, the necessity for making large currency payments should be established by reference to the company's normal business operations.

- Watch for unusual credits to receivables and unusual bonuses paid to employees. (Employees or customers may be reimbursed through such transactions for political contributions or other payments made on behalf of the corporation.)

- Investigate purchases from vendors whose names do not appear on the approved vendor list or from whom services (rather than goods) charged to cost of sales are purchased.

- Identify and examine contracts, invoices and similar evidential matter supporting service expenses -- including consulting and management fees, professional fees, advertising, promotion and public relations. Consider the reasonableness of charges for services received. Also, consider company controls which assure that services billed were actually provided.

2. Evaluation of areas of risk and exposure to illegal acts

In all audit engagements our auditors are to:

- Assess whether the nature of a company's business or the existence of warning signs of such transactions would suggest a need for instituting specific accounting and/or administrative controls designed to prevent or delimit the occurrence of illegal payments and/or the adoption of corporate policy statement; if so, communicate such a recommendation to the company. If
such controls or policy statement exist, evaluate and test compliance, as part of the review and testing of the system of internal control, whether such controls or policy statement seem to be effectively designed and operating.

3. Development of audit procedures applicable to those circumstances.

When matters are identified that require additional attention, we have developed corresponding procedures. For example, when amounts paid for services appear unreasonable, we request both a representation from the client as well as the recipient of the payment concerning the pertinent facts surrounding the payment.

We have also specified the additional procedures to be performed by our auditors when any of the following conditions exist:

- Inability to complete procedures (for example, receive a satisfactory representation from the client or the recipient of the payment for services in the above example).

- Audit evidence obtained is either contradictory or inconclusive.

- A matter the auditor believes is illegal.

- A matter that is illegal.

These conditions include all of those delineated in SAS No. 17 and incorporate the following additional procedures:

(a) Board of Directors -- inform client management and the board of directors of the matter. SAS 17 does not require this treatment of all such matters.

(b) Within our firm -- all such matters must be brought to the attention of designated specified personnel in our firm to assure adequate consideration. Ordinarily, our firm's internal legal counsel will also be notified.

When we are aware of a material possibly illegal act or a material illegal act, we further require that the company obtain the written opinion of outside counsel. The company, in such a case, should request counsel to address the following elements:

- Pertinent facts or assumed facts as counsel understands them. This documents the basis on which counsel will be rendering an opinion. Further, our auditors are required to perform appropriate auditing procedures with respect to the facts and assumed facts on which counsel's opinion is based.

5.10
The legal counsel's opinion should consider (1) whether there is a penalty which might attach to the payment, and if so, the amount; and (2) whether the transactions in question have significance with respect to income tax deductibility or other circumstances such as "cost plus" contracts.

Based on the stipulated facts and legal counsel's assessment of the legal ramifications, counsel versed in U.S. Securities Laws should be asked to explicitly state whether he has recommended that the client disclose the circumstances and whether non-disclosure by the company would cause him to withdraw from representing the company.

The advice of counsel concerning possible or proposed rectification.

We have just described, in summary form, the guidance we had developed for the review of controls or policies adopted by companies to prevent or delimit the occurrence of illegal payments. This guidance, we believe, is congruent with the Commission's suggestion to develop specific guidance concerning the "exercise of due professional skill and care." As this guidance also requires our auditors to review and monitor compliance with a company's adopted policy statement and/or controls, we not only agree with the Commission's suggestion but have substantively implemented it.

Reporting on Corporate Codes of Conduct -- The Commission states that "If the company has adopted a policy on illegal or questionable acts, the report by management in the annual report should include a statement that such a policy exists and that procedures have been implemented to monitor compliance."

Mandatory publication of codes of conduct may appear overly pious; instead we suggest voluntary publication, with emphasis on controls and their probable efficacy. We are also concerned about whether the auditor should be required to indicate in his report whether material weaknesses exist in the company's system in this area. We discuss this further in Section 7.

We believe that auditors should not be expected to evaluate the adequacy of corporate policy statements. They can report that provisions of a specific type are not included in a client's code, if there is some established standard for use in identifying omitted provisions. As we have previously recommended, we believe that such standards should be established by legislation or regulation.

"Legal counsel involvement" -- We are strongly in favor of legal counsel being in a key position as to determinations concerning illegal and questionable acts. And we agree with the Commission's indication that legal counsel has a greater role than
he is now willing to fill, in the area of legal uncertainties, litigation, and claims both asserted and unasserted. (5-10) (In general, we favor a separate report by legal counsel, but will discuss this in section 7.)

* * * * *

Earlier in this section we summarized the procedures pursued in our firm in marshalling the advice we and a corporate board of directors need in addressing illegal and questionable acts. It is only fair to state that our success in accomplishment of those procedures has not always been total, and never without some debates with lawyers in significant cases.

This problem has been too long awaiting a resolution. Auditors, attorneys, management and the board of directors should cooperate in arriving at the best possible consensus in a given situation. With today's governmental rhetoric about "wants" but vacuum in specifics, no one of these four groups should succumb to extending beyond his appropriate level of participation. Categorically, auditors should not be the victims of a bilateral squeeze by lawyers and government.

It goes without saying that the relatively small number of companies disclosing illegal or questionable payments should recant and others should not begin -- all in the framework of a workable definition of acceptable and unacceptable business practices -- here as well as competitively abroad.

As the "abuse" of corporate perquisites now comes under the government's microscope, it is more important than ever that the Commission on Auditors' Responsibilities recommend a limiting line of the auditor's role. The business community should organize to support the auditor's proper role rather than to allow the auditor to become the target and shield.
(5-1) Similarly, SAS No. 17, "Illegal Acts by Clients," is reactionary in dealing with this subject, as is our firm's proprietary Technical Letter No. 154 on "Illegal Payments." We think reaction is better than no action, but this is not a deliberative way to steer the course of a profession.

(5-2) Social Accounting is mentioned briefly in the Commission's Report at pp. 69-70. The AICPA Committee on Social Measurement has since published The Measurement of Corporate Social Performance, which delves into the subject in depth.

(5-3) Refer to our comments on pp. 1.5 and 1.6 on auditors not being "panacean equalizers."

(5-4) The Report says: "For example, auditors are familiar with the federal income tax laws and would be expected to recognize tax evasion by a client." The discovery of tax fraud is subject to the same limitations as exist in the auditing area, e.g., collusion and forgery.

(5-5) In our technical letter, we define "illegal payments" as "direct or indirect payments (in cash or in kind) for the express or implied purpose of obtaining favor, in an illegal manner. ('Favor' should be understood to include both active and passive matters. Forbearance (failure to prosecute, for example) is, therefore, included. 'Illegal manner' refers to either or both the payment or the means used in bestowing favor.) Such payments would encompass the broad categories of direct or indirect political contributions, bribes, kickbacks, and payoffs. These matters have been the subject of a number of recent SEC actions. The use of the phrase 'illegal payments' should be understood as having applicability only to the payments mentioned in this paragraph.

"We believe the auditor should not be held responsible for failure to identify and/or properly evaluate all payments which are or could be alleged to be illegal, provided he has performed his audit in conformity with generally accepted auditing standards. He should, however, be alert, during his audit, for illegal payments which could have a material effect on the financial statements."

By contrast, SAS No. 17, paragraph 3 states: "The determination of whether an act is illegal is usually beyond (the auditor's) professional competence. The auditor's training and experience, however, ordinarily should provide a
reasonable basis for an awareness that some client acts coming to an auditor's attention in the performance of his examination might be illegal. Nevertheless, the further removed an illegal act is from the events and transactions specifically reflected in financial statements, the less likely the auditor is to become aware of the act or recognize its possible illegality. For example, violations of the Occupational Health and Safety Act are not ordinarily specifically reflected in financial statements, and the auditor ordinarily does not have a sufficient basis for the awareness needed to recognize the possible illegality of such violations.

(5-6) For example, an imputation of "whatever" a code of conduct is popularly expected to encompass regardless of what it says.

(5-7) The source of this data is our firm's Technical Letter No. 154, "Illegal Payments," November 30, 1975, and is provided in the event the Commission intends more specifics in its final report.

(5-8) We provided our auditors with samples of actual published policy statements; we did not require that the policy be published outside the company.

(5-9) The remaining comments in this subsection are paraphrased from Touche Ross TL No. 154.

(5-10) Touche Ross encourages the Commission to recommend a separate report by legal counsel included in the annual financial report. Counsel should go "on the line" for the adequacy of disclosure of uncertainties and as to the extent of the corporation's compliance in all material respects with applicable laws and regulations. If need be, this can begin by having the lawyers' letter required under SAS No. 12 published; after all, much consternation over the content of this letter related to its probable discoverability, and therefore that it had to be written with the utmost care. That being the case, we see no reason why lawyers' audit letters should not be further worked into a "lawyer's certificate." Of course, the lawyer may appropriately state that he is an advocate for the client and therefore has an interest in the outcome of the matters he is addressing.
The Commission's Tentative Conclusions on the Audit Function

- The audit is a function to be performed during a period of time, not only as to a particular set of financial statements.
- Auditors should review and test the entire system of internal control and form a conclusion as to the absence of material weaknesses during the year.
- Management should report on the adequacy of its system of internal controls, material weaknesses therein, and its response to the auditor's suggestions for improvements.
- The auditor should report on his agreement with management's descriptions and should describe material weaknesses not disclosed by management.
- The audit function should expand to encompass financial information released regularly during the year; tests throughout the year would be required. In particular, reviews of published quarterly financial statements would be part of the audit.
- Reporting of timely auditor involvement apart from annual reporting is needed, but an audit base should be prerequisite.
The Setting of the Audit Function and Considerations Affecting Its Extension

The Commission recognizes that although auditing is an economic function, government, mostly through the SEC, has interceded to assure minimum audit requirements for publicly held companies. Though cost-benefit analysis is considered and the Commission agrees it is appropriate to apply in principle, the inability to develop a practical method for application of cost-benefit analysis to auditing is a serious problem. The Report concludes that: "If society needs new services, the public accounting profession should meet those needs within its abilities to deliver the requested services."

In the absence of cost-benefit measurements, the Report attempts to provide a framework to guide the evolution (although there are a few "immediate" recommendations) of the audit function into areas beyond the annual audit of financial statements. The main consideration is that a great deal of information reported by corporations and assimilated by users is released throughout the year, not in connection with the annual report. It is, therefore, logical to the Commission that the audit function be continuous -- applied to the processes used to generate financial information, as well as to the information itself. If the auditor "attests" to these processes throughout the year, users will be given greater assurance that non-annual financial information has improved in reliability.

We believe Section 6 is important and useful, especially in recognizing the importance of benefit-cost analysis as an underlying concept, and in establishing workable criteria for deciding when an extended service is within the auditor's province. We too have no immediate answers on costs overall, but we think the Commission might have been able to obtain cost ranges for certain of the specific suggestions contained in this Section as well as throughout its Report.(6-1)

We believe that, although the SEC is acting conscientiously in establishing many audit and related requirements for publicly held companies, the market concept should be the basic concept observed in all cases where it has not been clearly demonstrated that regulation is necessary. And regulatory necessity should require a showing that instances of significant loss to users would have been avoided by extension of the audit function or that losses could reasonably be expected to be prevented or minimized in the future through regulation.

The difficulty with even this kind of standard is that the situations which impel greater audit effort often gain great notoriety, and thus may be viewed out of perspective. They often result in increasing the cost of all audits to avoid problems of a breadth yet to be demonstrated. To allow this without cost-benefit deliberations seems to us to be wrong.

6.2
At this point in time, given recent improvements in auditing standards in the areas of management fraud, illegal acts and review of quarterly financial statements, we see no other potential areas of extension of auditing services which should be made mandatory for either publicly or privately held companies. We believe current practices augmented by a requirement that the auditor's report regarding quarterly statements be filed with Form 10-Q,(6-2) establish a responsive minimum.

Accordingly, companies should at their discretion engage auditors to perform additional services which the directors and management believe will enhance their position with users. Or users (shareholders, creditors and others) may prompt such additional services on their own behalf. These market-based approaches are entirely appropriate and can be disclosed and reported upon in compliance with the Commission's recommendations. Companies not electing such services could indicate their responsibilities for controls and financial information and state they do not believe auditor association is necessary.(6-3) Because much of the data will be subject to audit annually, a "track record" will be established to provide a measure of reliability about those assertions lacking timely auditor involvement. If instances of misrepresentation emerge, the Federal Securities Laws seem to us to be more than an adequate redress.

The Boundaries of the Audit Function

While it is true that relationships between the auditor and client tend to be continuous, there must be considerable specification before the auditor becomes the centurion of corporate "propriety." That auditors cannot be oblivious to events occurring between annual audits was established long ago.(6-4) Accordingly, the specific responsibilities the auditor has in his continuing relationship must be spelled out and as additional responsibilities are added, we are sure the Commission agrees this should be done deliberately, rather than by a broad sweep-in.

The idea of reestablishing the boundary(6-5) of the audit function based on "the auditor's competence and the existence of operational criteria"(6-6) may not, however, be an entirely valid approach. In Section 1 the Commission suggests a societal value role, yet in Section 5 there is a hint that later, though not presently, auditors can become versed in many disiplines. The only way to extend boundaries is to consider each matter on its own merits in a logical sequence.(6-7)

The Commission recognizes that the competence criterion must be limited (p. 57), but could be more assertive in its final report, not relying on the assumption that illogical ascriptions to auditors will not occur.
As we have already discussed in Section 2, financial information needs identification as to its inherent degree of factuality or interpretation. The Report recognizes this distinction in discussing "the importance of verifiable information" (p. 58) but leaves the impression that the audit function should heavily lean toward the verifiable. In our response to the Financial Accounting Standards Board on the Objectives of Financial Statements, we recognize that financial statements must include the range from factual through interpretive, but excluding the speculative. Our broader view, therefore, makes us somewhat more sensitive to the extension of the auditor's role. Verifiability will be a test, but we predict not a compelling one.

Need and Mechanism for Expansion of the Audit Function

The Commission recommends ultimate extension of the auditor's involvement to the entire reporting process. We agree in concept, so long as there is specification of the elements of the financial reporting process in which the auditor gradually becomes involved over time, along with standards for his involvement, and a measure of protection acknowledging that the further involved he becomes, the less reliable his assurance is going to be.

"Auditing the financial reporting process" — We agree that the auditor's relationship with publicly held clients should be a continuous function, including perhaps areas beyond those discussed by the Commission in the ensuing subsections. We have several overall suggestions to make at the outset:

1. As an objective, the annual audit should be completed and reported on within 90 days after year-end. (6-8)

2. Quarterly statements should be reviewed in accordance with SAS No. 10 and reported upon as part of Form 10-Q using a positive-assurance report.

3. Management should indicate in its report (as recommended by the Commission in Section 7) its responsibility for the company's internal control and financial information, and the extent and consequences of its election to have the independent auditors extend their procedures beyond mandatory levels.

4. The independent auditor would address in his report the quality of content of management's report.

"Expanded study and evaluation of internal control" — The Report of Tentative Conclusions asserts (p. 60): "The first step ... which should be adopted immediately, would be to require the auditor to expand his study and evaluation of the controls over the accounting system to form a conclusion on the functioning of the
system during the year." And on p. 61, the recommendation continues: "The auditor should be required to review and test the entire system. The objective of this study and evaluation would be to enable the auditor to reach a conclusion on whether controls over each significant part of the accounting system provide reasonable, though not absolute, assurance that the system is free of material weakness."

Implementation of these recommendations on all publicly held companies would be extremely costly, in our opinion. Although many audits are done in a way that facilitates this approach, we think most are not. The approach now taken, sanctioned by professional standards, is usually based on an economic analysis. A preliminary evaluation of internal control for material weaknesses is made in all significant areas, but systems testing may or may not be performed depending on many practical considerations relating to substantive tests.(6-9) When systems tests are performed, a greater amount of detailed systems information is required than when performing only a preliminary review of the system without testing.

Requiring systems tests in all significant areas will increase total audit effort greatly and could detract from a more effective overall annual audit result. It is conceivable when auditors are forced to extend systems (compliance) testing to comply with this recommendation, that they will be motivated to reduce other (substantive) tests as much as possible. This may cause excessive risks in auditing year-end financial statement balances, despite the fact that the audit of the annual financial statements must remain the primary focus of the audit function.

As we have stated in Section 4 regarding fraud detection (p. 4.8) the Commission's apparent assumption that the auditor studies and evaluates all internal controls, at least in large publicly held companies,(6-10) is not quite correct. The thought that this recommendation should be adopted immediately also suggests the Commission views the undertaking as a relatively easy one, and therefore may misunderstand the effect we think it would have on audit planning practices.

The Commission could be very helpful if it were to give its basis for reaching this conclusion. We would appreciate the opportunity to provide a constructive critique in this area, based on our firm's current research and recent adoption of a more conceptualized audit approach.

The objective stated by the Commission (p. 61) -- to enable the auditor to reach a conclusion and provide reasonable assurance that each significant part of the system is free of material weaknesses -- is a desirable one, but in itself is based on the idea that control systems should deter and detect material management fraud and illegal or questionable acts. In most respects, internal accounting control systems work best as safeguards against defalcation of assets and border on impotence when standing guard against collusion and unique management activities.
Thus the reporting on this subject anticipated by the Commission in its discussion of "The Effect on Reporting Practice" and in Section 7 could tend to overassure audited financial statement users, especially by the proposed requirement that auditors now begin to evaluate all significant systems.

Auditors now make recommendations to management concerning material weaknesses. It is true that these could be disclosed by management along with an indication of whether they were received as part of the regular audit or as the result of a special extension of services. But a missing ingredient in the Commission's analysis seems to be failure to confront the prospect of extreme variability in

- auditors' perceptions of what constitutes a material weakness(6-11)
- the incisiveness of auditors' "suggestions" for the correction of weaknesses.

Thus, the acceptability of management's response to auditors' suggestions -- particularly if management opines that the suggestions deal with immaterial areas or simply do not make sense -- will be as difficult to assess as the validity of the auditors' perceptions in the first place. We recognize that eventually objective standards for identifying, describing, cost-evaluating and rectifying material internal control weaknesses must come, but considerable advance preparation is needed. There is, simply, a need to avoid contests with management over published words until all parties know what they are talking about, and until managements and auditors know how to say it straight.

Further, the Commission should also consider how users might interpret this information.(6-12) Many users do not understand the nature of financial statements and financial reporting.(6-13) We have serious doubts that they would understand anything as technical and circumstantial as internal controls. We believe research on communicating such matters to non-accountants should be conducted before details are included in all published annual reports. If the Commission nonetheless believes in immediacy of action, our example of what management could say is as follows:

"We have engaged our auditors to extend their review of internal controls beyond the levels normally required for their annual audit. We intend to cycle this review so that full coverage is accomplished every three years, as part of our program to reasonably maintain the effectiveness of our accounting and control systems to be responsive to changes in our business and administrative practices.

"Because internal control systems design and effectiveness is a highly complex matter we have not included a copy of our auditor's report on internal controls herein. However, it is available and can be obtained by writing our corporate
office. We have reviewed all of its contents with our auditors and have either implemented or begun implementing all those recommendations where, in our judgment, the actual or potential benefit from the recommendations will outweigh their related costs."

"Timely involvement in the financial reporting process" -- The Commission discusses at some length (pp. 62-67) that "... the audit function should expand to include obtaining an understanding of the process used by the company to prepare significant financial information regularly throughout the year ..."(p. 62); that "... tests throughout the year would be required ..."(p. 63); and that "... auditors (will) change the traditional approach to reporting," to dislodge the user's fixation on auditors' reports as a stamp of approval.(p. 66) An illustrative interim report is given.

We agree, as stated earlier in this Section, that the auditor should be involved in the quarterly reporting process of his publicly held clients. The optional approach provided under SAS Nos. 10 and 13 seems inappropriate when under ASR No. 177 companies are required to present, in an "unaudited" footnote, four quarters' financial data (substantially a Form 10-Q tabulation); and the auditor would be required under SAS No. 13 to remark in his report if he knew of any material misstatements therein.

Paragraph 31 of APB Opinion 28 (1973) has required disclosure of unusual, infrequent and year-end adjusting items in the absence of a separate fourth quarter report. Thus, auditors have for years paid careful attention to this, and therefore have given at least some attention to the proper dispersion of accounting events in all four quarters.

The idea of timely involvement is not new, and it need not be elaborated that auditors' reluctance to acknowledge formal attestation stems from the litigious environment -- one that demands a rigorous standard the auditor can observe lest the standard be as flaccid as plaintiffs allege and courts adjudge. This is the problem to attack; yet the Commission seems to have not fully addressed it.(6-14)

For example, on page 63, a limited review under SAS No. 10 is described as something less extensive than an audit. We all know that. Since it is not possible to precisely define an audit, anything contrasted in relation to it is also not definable. Yet the Commission suggests an expansion, but still less than an audit of quarterly information.(6-15)

The Commission's exemplary discussion on the content of interim reviews (p. 64) adds thought(6-16) to the recommendation, but not definition. If anything, this discourse deals with known problems susceptible (as are most auditing topics) of continuous debate.
We urge the Commission to define a limited review separate from considerations of auditor risk, so that it can be viewed in a truly conceptual state. We think that the proliferation of negative assurance -- which in our view is an inappropriate attestation blended for defensive purposes -- might even be reversible if concept could be distilled for discussion purposes.

All this leads us, therefore, to agree with the goals stated by the Commission on page 68:

- "... it may be possible to determine the probabilities that the procedures in each form of assurance will detect various errors, omissions or misrepresentations."

- "... the distinctions between audits and reviews should gradually become less significant and the lack of understanding them less of a problem."

Separating jeopardy from the reasoning process could help in achievement of these goals.

The exemplary "interim report of independent auditors" (p. 66) is certainly an improvement over those now sanctioned by SAS Nos. 10 and 13. It would be even further improved by substituting the following wording for the first and second sentences of the third paragraph:

"We have reviewed the company's process of preparing quarterly financial information; we believe the process is adequate for that purpose, and we have observed that the process was used in preparing the accompanying quarterly data."

Note the absence of negative assurances in our wording and the avoidance of "material weaknesses," which we have challenged earlier in this section.

Need for an audit base -- to accomplish the recommendations made so far in this section, it will be necessary that the Auditing Standards Board in cooperation with the SEC develop the "auditor of record" concept (p. 66). We wonder whether continuous involvement means that at least an entire year must be dealt with by an auditor and that there should be no midstream changes in auditors. If so, there could be considerable difficulties in implementation. (6-17)
The Commission's Tentative Conclusions -- Beyond the Audit Function

- Auditors should be consulted on current releases of material financial information but should not separately report thereon.

- The audit function must be extended to other interpretive information in the annual report not contained within the financial statements; present requirements in SAS No. 8 are too limited.

- Auditor reviews could be made of the forecasting process if it becomes standardized to the same extent as other accounting information.

- Auditors should not become involved in evaluating management's decisions or performances as to efficiency, economy and effectiveness.

"Current releases of material information" -- We agree that public reporting based on a very limited degree of involvement is an inappropriate and undue fragmentation of the audit function. But we believe it prudent to continuously consult internally with clients regarding all complex and significant financial accounting and reporting matters. For example, press releases and Form 8-K disclosure of material financial events are best addressed when they may yet be revised.

The Commission could also have addressed certain other requirements for fragmentary reporting, for example --

- ASR 138 -- the auditor's letter stating that large or unusual changes are treated in conformity with generally accepted accounting principles

- New York Stock Exchange letter on the appropriate use of pooling of interests accounting for a business combination

- Instruction H-(f) of Form 10-Q (and SAB 6) requiring an auditor's preferability expression for an accounting change (though this is alluded to in Section 2).
We recommend that the Commission in its final Report take a position against these and similar situations, in favor of the developing continuing association concept.

"Other annual report data" (6-18) -- It is easy to support the recommendation of "... an immediate extension of the audit function to other information in the annual report" (p. 68) because there is little specification of what the Commission wants beyond the existing requirements of SAS No. 8. If it is simply a matter of embracing that material in the report on the audit function (Section 7), that can be done, though care must be taken to be specific about what is included and what responsibility the auditor takes for it as its content of management interpretation increases. The auditor should deal with information "within the limits of financial accounting"(6-19) and avoid only marginally related areas such as marketing and personnel achievements and qualifications.

Our recent experiences with SAS No. 8 point out a weakness that perhaps could be rectified by the Commission being more specific in its final report. We have observed differences in annual report textual, tabular and summary descriptions of financial statement information, but the presentation outside of the financial statements is so clearly explained as differing that no reader could misunderstand it -- though he might be utterly confused about the reason for the difference. One example is the presentation of foreign currency translation gains and losses, neither an extraordinary item nor to be stated net of tax or per share on the face of an income statement, but sometimes explained and presented so to appear elsewhere in the annual report.

It is not clear that SAS No. 8 requires any auditor action in such a situation -- and partly at fault is the lack of guidelines or standards for summarizing, or what constitutes an unacceptable summary of, financial information.

"Financial forecasts" -- A distillation of the Report's three paragraphs on forecasts is: "Not now!" The Commission probably has little choice but to stand aside, given the burden of all past and present oriented matters to deal with. Touche Ross is in favor of experimental publication of financial forecasts, along with auditor association. Among our reasons are:

1. The profession has made more inroads than acknowledged by the Commission:

- The Accounting Standards Executive Committee of the AICPA has issued its Statement of Position No. 75-4 on "Presentation and Disclosure of Financial Forecasts."

- The AICPA's Management Advisory Services Executive Committee has published "Guidelines for Systems for the Preparation of Financial Forecasts (August 1975)."
- The SEC has proposed approaches to forecast presentation in securities acts filings.

2. Touche Ross is a strong proponent of current value accounting which in ideal concept would incorporate present value of future cash flows. Experience with forecasting would assist in achieving recognition for current value accounting.

This missing link is what the auditor/attestor should say about the forecast. Considerable efforts have been expended in the Auditing Standards Executive Committee and continue in a Task Force -- and part of the dilemma is the ubiquitous litigation spectre. We have developed our own "positive assurance" form of reporting (not vouching, of course, for achievability), awaiting AudSEC resolution.

We urge the Commission to reconsider the proper place of ongoing financial forecasts, as it is a matter on the near horizon of auditors' responsibilities.

"Efficiency, economy and effectiveness" -- The Commission recommends that the audit function should evolve to include these kinds of disclosures required by business enterprises, but no mention is made of materiality. Of course, not all governmentally required disclosures are of a materiality warranting auditor involvement.

Touche Ross has publicly urged the Financial Accounting Standards Board to step up to the delineation of accounting standards for governmental units.(6-20) We believe the Commission may have erred in concluding that, as part of the auditor's necessary involvement in governmental units, efficiency, economy and effectiveness should not be dealt with; the accounting standards to be developed may contemporaneously incorporate aspects of this subject. As has been pointed out in the "GAO Yellow Book" and the AICPA's explanation of it(6-21) auditors can perform against sufficiently specified quantitative standards.

If the auditor may have to confront requirements for evaluation in audits of governmental units, the Commission's current conclusion that such activity is incompatible with commercial enterprise auditing may not be sustainable. At the outset we admitted that the auditor is a reporter and not an evaluator of financial information, but auditing against objective standards, however defined by bodies empowered to do so, is eminently within the auditor's domain even for private enterprises.

We think the incompatibility issue can be resolved by careful definition and appropriate joint participation of other appropriate professions. Much the same is true of reporting on the effectiveness of social programs.
We recommend that the Commission restudy this area and if possible delineate the compatible, feasible services from the subjectively evaluative judgments which must be made by users.
Footnotes to Section 6

(6-1) On occasion, the SEC requests that respondents to its proposals comment on implementation costs. Responses to the SEC might provide a start.

(6-2) If this were to be done, we concur in the Commission's opinion that such reports should communicate in a positive fashion, as contrasted to the negative assurance report now prepared in accordance with SAS No. 13.

(6-3) The "me too" syndrome is a difficult one to deal with. We are not prepared to fully explain how a management dismisses a competitor's more extensive auditor involvement; this underscores the possibility of the Commission's recommendations eventually covering all business even if not now intended.

(6-4) For example, Yale Express, SAS No. 1, Section 561.

(6-5) "Boundary" connotes a fixed position. The Commission seems to be in favor of a floating fence, as the needs of society vary -- usually expanding.


(6-7) An example of such a decision model is:
1. Identify the societal malady.
2. What seems to be needed within the limits of financial accounting, reporting and auditing?
3. If the need were fulfilled, to what extent would the malady be corrected?
4. What specific recommendation is apropos?
5. Is it feasible? How? Any side effects?
6. Who is to carry out the recommendation?
7. When should it be done?
8. What will it cost, considering all the above? Is it more expensive than the malady? If so, what compelling reason is there to do it anyway?

(6-8) However, in our discussion of time pressures in Section 9, page 9.19, we consider obtaining additional 10-K flexibility from the SEC.
(6-9) Our firm's recently adopted conceptual auditing approach is described in Section 9, page 9.13 and footnote (9-13).

(6-10) Several Commissioners remarked at the public meeting on June 22, 1977 that they felt this recommendation would not be too problematic on large audits.

(6-11) Even SAS No. 1, paragraph 320.68, defines a material weakness as the auditor beholds it: "...condition he believes to be a material weakness for his purpose." (Emphasis added.)

(6-12) On page 62, the Commission supports by a citation from The Philosophy of Auditing that "Users have the right to expect the independent auditor to inform them of any material uncorrected weaknesses...." The disclosure activator, "sufficiently important to influence the judgment of one reading and acting on the financial statements" is a prime example of auditor circumfluence. It seems to us especially in the area of studying, testing and reporting on all significant internal control systems, the Commission has little concrete evidence of need, utility and communicability, and is responding to a valid concept still in an embryonic stage.

(6-13) See Objective One of FASB's Tentative Conclusions on the Objectives of Financial Statements of Business Enterprises, discussed in Section 2 hereof.

(6-14) The "safe harbor" concept (p. 147) does not even mention interim reporting association.

(6-15) Some auditors favor no quarterly involvement unless it were to be an audit. This tempts us conceptually, were it not for cost and manpower considerations.

(6-16) Here the Commission suggests that increased knowledge of a company's budgets, earnings plan and operating activities would assist the auditor in evaluating the cumulative effect of the selection and application of accounting principles. No doubt every little bit helps. But the need for accounting principles to be made more specific to circumstances is the most important ingredient. We have discussed this subject at length in Section 2.

6.14
(6-17) The Commission's comment on page 67 that a new auditor's audit must have progressed sufficiently to provide a base equivalent to what would have existed if no auditor change occurred raises the question of interim auditor changes. More specific transitional details need to be worked out. Naturally, uncompleted "cycles" could be commented upon by the superseded auditor, along with a statement of the extent to which any of his earlier work might be affected by failure to serve out his "term." Or, arrangements might be made for the succeeding auditor to reassume responsibility for the earlier, uncompleted cycle.

(6-18) We presume the shareholders' report, not the 10-K, is meant.


The Commission's Tentative Conclusions

- A report on the entire audit function is required.
- Management is encouraged to present a report acknowledging its responsibility for the representations in the financial statements.
- A reference to consistency should be eliminated from the auditor's report.
- Accounting changes should be described in a standard note to the financial statements.
- The present method of referring to other auditors should be eliminated.
- Users of unaudited information should be informed about the work done and the assurances intended rather than merely that an audit was not done.
- The auditor should be present and available to answer questions at the annual meeting of the shareholders.

Major Communications Deficiencies

In some respects what the Commission perceives as deficiencies in auditors' communications is a reaction to user disinterest bred by years of familiarity with the "same old words." True, there are many needs for better communication, and we are inclined to agree that improvements are achievable simply as a result of significant reformatting. At a minimum, the "seal of approval" misperception will be dealt a well deserved blow, and at best, users will pay careful attention to the auditor's message, especially if its content can be kept somewhat flexible and evolving.
A New Approach to Reporting

"A report on the audit function" -- The overall thrust of this section is to create a longer, more informative auditor's report, so as to impel users to read it in order to obtain an understanding of the auditor's responsibilities and assurances. This is in contrast to the standard two paragraph short-form report, now viewed as a seal of approval.

We suspect that some users will take the same approach to most anything the auditor proffers, but agree that some improvement is achievable as a result of a basic reconstruction of the auditor's report for the first time in almost thirty years.

The Commission's recommendation that "A report on the entire audit function is required to provide sufficient flexibility to convey the required information to users" is, however, a mammoth undertaking, which will require considerable efforts of the Auditing Standards Board and the indulgence and participation of the SEC.

Though we wholeheartedly support it, we have misgivings about the suggested "standard/variable" paragraphing. In the last analysis, it seems the Commission, in attempting to get the readers' attention, is not advocating a total free-style; we agree that would not be desirable simply because people communicate in different manners and some are more successful at it than others.

The Commission's concept, therefore, is good. But we perceive difficulty with "standardized alternative phrases or paragraphs" that change with the circumstances, as these too could become contentious with clients if they are highly subjective as to when they are used or omitted. Naturally, a paragraph concerning the existence of an audit committee will not be a problem so long as one exists, but a paragraph dealing with material weaknesses in the system of internal controls not adequately disclosed by management will bring on debates no less heated than sometimes now occur in acclimating clients to the need for a qualified opinion. Specifically, because "material weakness" will be a subjective determination (7-1), its mention in the auditor's report will be considered a negative factor by managements; difficulties are bound to ensue. We cannot, of course, avoid this given the role occupied by the auditor, but we recommend that the Commission address this problem to provide additional guidance for the auditor if possible.

In general, the illustration of a revised auditors' report on pages 77-78 seems appropriate as a general direction. Although it is an illustration and the Commission may not attach vital significance to any of its exemplary factors, we have several comments about it:

1. Some recognition should be given (if it is a fact) that the auditors assisted management in the preparation and presentation of the financial statements; this is not covered by the first paragraph.
2. In the third paragraph, the auditor is asked to state the obvious: "We believe our auditing procedures were adequate in the circumstances to support our opinion." The user is entitled to rely on that whether or not stated. When he believes his procedures were not adequate, the auditor should make that clear by expressing a non-standard opinion.

3. The paragraph concerning the review of information appearing in the annual report outside of the financial statements seems innocuous. We believe more specification of what was reviewed should be given.

4. Finally, in referring to meetings with the audit committee, qualitative phrases such as "met with...sufficiently often" should be avoided but the facts should be stated. If the auditor believes meetings or contact have been insufficient, he should so state.

In sum, the auditor should make a series of positive, reasonably factual statements. The user should be entitled to expect that all significant deviations or dissatisfactions will be reported by the auditor.

In a sense, this report format suggests a conglomeration of issues which are of contemporary interest. We do not fault the Commission for selecting items of current popularity, as long as the Commission recognizes the content of the report would necessarily change from time to time. Presumably, the Auditing Standards Board would identify important subjects as they emerge, and create new "standard" paragraphs to be used if applicable; at the same time, they could decide on the proper time to abandon(7-2) an existing topic.

"A report by management" -- The Commission recommends that "...management (should) present a report with the financial statements that acknowledges the responsibility of management for the representations in the financial information, ... provide management's assurances that the information is presented in conformity with generally accepted accounting principles appropriate in the circumstances and that all material uncertainties have been appropriately accounted for or disclosed." This recommendation also suggests that management make a statement concerning the involvement of legal counsel; as we have indicated earlier, our preference is that legal counsel's report actually be published.

The Commission also recommends that management assess its accounting system and its controls over it, and describe the company's response to material weaknesses identified by the independent auditor. If this is to be done, it should not be limited to only those weaknesses identified by the independent auditor; knowledge of weaknesses could come from many sources, especially including the company's own internal auditors.
The illustration of a report by management appearing on pp. 79-80, is a good one. We think it should be kept reasonably neutral and factual in tone, and that management should not be permitted to "puff" (e.g., "impress users with the quality of management"). Considerable care needs to be taken so that rhetoric does not govern.

Since the adoption of such a report could be an expensive undertaking by the corporate community, experimentation would be advisable, based on guidance provided by an organization such as the Financial Executives Institute. We suggest that, thereafter, the SEC first require this of larger publicly held companies, with a minimum content and no limit on maximum content other than the need to maintain factuality. The minimum content should be reasonably parallel to matters to be deemed by the Auditing Standards Board as necessary in the auditor's new standardized but flexible reporting format.

This seems an appropriate point to suggest to the Commission that, because the auditor as well as management are not experts in all disciplines and must therefore make reference to other experts in connection with financial presentations, the reports of such other experts be included, or at least paraphrased, in management's and/or the auditor's reports. We have already mentioned lawyers, but we believe the list could be extended to geologists, actuaries, appraisers, architects, engineers -- whichever professions are appropriate, given materiality to the financial reporting process.

In this regard, we believe that SAS No. 11, "Using the Work of a Specialist," is incorrect in stating that the auditor should not express reliance on other experts, but should be sufficiently familiar with their disciplines so as to be satisfied that they performed appropriately. We may be deluding ourselves about the abilities of auditors; other professionals should be ready to step up to their own responsibilities. Of course, the auditor should assure that the information used by other experts in their disciplines is supported by the company's records, and that the resulting information from the expert is incorporated into the company's records and/or financial reporting process as required.

"...Reporting on consistency" -- We agree that the reference to consistency should be eliminated from the auditor's report. When an approved accounting change is made, its recognition in the auditor's report is usually referred to as a "consistency exception" when it is not an exception in the usual sense of that term.

"A standard note...covering accounting changes" -- APB Opinion 20 should indeed be amended for more matters than this. We agree with the Commission's recommendation, pointing out our concern that proliferation of "standard footnotes" is an activity that should proceed with caution.
As long as the FASB is at it, Opinion 20 should be amended to give criteria for the manner in which accounting changes should be made, rather than continuing the prescription that all should be made by cumulative catch-up adjustment. The FASB's brief history itself shows that almost all promulgated changes are prescribed retroactively.

Even when changes are made retroactively, we do not think it necessary for the auditor to state that the currently presented comparative financial statements are not those previously presented. The standard footnote could be augmented by adding "(Restated)" to column headings.

"Use of the work of another auditor" — The Report of Tentative Conclusions (p. 82) identifies the approaches presently available to principal auditors in this area and offers two substitute possibilities:

1. Do enough work so that the secondary auditor need not be mentioned (that is, accept responsibility for the secondary auditor's work).

2. Require management to present the reports of the other auditors of material components of the financial statements. If the other auditors' reports are not included, the principal auditor would take exception to the adequacy of disclosure.

We believe that the present form of reporting when there is divided responsibility between or among auditors should be eliminated. There is little wonder why financial statement users are confused and believe such a report is a qualified opinion. Especially those users having little knowledge of the auditing profession and its professional standards must find it difficult to assess the meaning of the opinion.

There exists another level of confusion arising out of the shared responsibility concept. Other professionals do not understand the reason why an auditor can share responsibility with another auditor but not among others such as lawyers, actuaries and geologists. Other professions having rigorous standards for admission and high educational requirements for their disciplines cannot appreciate the reasoning in current auditing literature for allowing an auditor to rely only upon another auditor.

The present auditing standards regarding shared responsibility have ancient origins. Many developments in the auditing profession have increased the scope of the auditor's role even before the Commission began to study it. Auditors are now involved with unaudited data contained in financial statements such as interim data and replacement cost data, are responsible for consistency of other information appearing in financial reports, must perform procedures to attempt detection of errors and
irregularities and illegal acts, and more. Yet our auditing standards have not been updated with respect to the concepts and standards of shared responsibility.

We believe that, today, shared responsibility brings with it inefficiencies and possible risks in the audit process. These inefficiencies, and extra auditing to guard against the risk of information lost in a crevasse between the dual auditors, are passed on to clients in the form of higher audit fees. We believe that the time has come for the profession to reassess the concepts of shared responsibilities -- to step up to the need for only a single auditor to be involved in the audit of an entity and its controlled subsidiaries (i.e., those which are not nonsubsidiary investees).(7-3)

"Inconsistent and uninformative reporting on unaudited information" -- The Commission recommends (p. 83) that "users should be informed about the work done and the assurances intended rather than merely about the audit that is not done" when independent accountants are associated with unaudited financial statements. We agree that the implication given by the accountant when he affixes his name on an unaudited report is not understood. The comfort taken by the users of such financial statements usually bears little relationship to the degree of the assurance intended by the accountant (who may himself not be sure of what he is expected to convey).

We believe that this matter requires intensive and careful study, at the same time (hopefully soon) as the FASB or some other body gives the proper attention to the application of generally accepted accounting principles to smaller or closely held businesses. Additional guidance is needed on how to describe procedures performed along with what limited though positive assurance can be given therewith.(7-4)

"...Communication with interested parties" -- We agree that informal and selective access to the auditor should be discouraged, and that a "requirement that the auditor be present and available to answer questions at the annual meeting of the shareholders" is the proper approach. Present SEC requirements provide that companies state in their proxy statements whether the auditor will be present at the meeting to answer questions. Although we haven't researched this, we assume that many if not most publicly held companies follow this practice, and also invite the auditor to make a statement to the shareholder assembly.

Difficulties arise, however, in ascertaining what questions are appropriately directed to the auditor, or what kind of statement the auditor should make in the absence of questions. It is not sufficient to simply make an announced appearance, as that is a mere formality.
We recommend that the auditor be encouraged to review potential major questions with management and the meeting chairman prior to the shareholders' meeting, to agree on the nature of questions properly answerable by the auditors, and what the auditors' probable answers would be, so that management, the directors and the auditors have an organized approach. Furthermore, we recommend that, as a minimum, when there is nothing else to report (this will often be the case), the auditor make a statement to the shareholders paraphrasing his auditor's report so as to both serve an official function and to stimulate the thought process of the audience.
Footnotes to Section 7

(7-1) Refer to our comments on pages 4.7 and 4.8 regarding the problems of having the auditor evaluate all significant fraud controls, and on pages 6.4 - 6.7 regarding the inappropriateness of evaluating all internal controls annually.

(7-2) Experience shows that disclosures once adopted are virtually impossible to eliminate. Barnacled auditing and accounting disclosures seem moved only by major undertakings such as the Commission's Report and the FASB's Conceptual Framework Project.

(7-3) We believe that the Institute has retained the concept of shared responsibility out of deference to the sensitivities of smaller firms, and that may not be sufficient in the face of the overwhelming need for coordination of all elements of an audit engagement -- particularly when the auditor is to be held responsible for the matters recommended by the Commission.

(7-4) On page 66, in referring to timely reporting on unaudited interim financial information, the Report states:

"Eventually, after experience is gained, it may be possible to determine the probabilities that the procedures in each form of assurance will detect various errors, omissions, or misrepresentations."

This objective is, of course, viable in the context of all unaudited information with which the auditor is associated.
THE EDUCATION, TRAINING AND DEVELOPMENT OF AUDITORS

The Commission's Tentative Conclusions

- "A four-year liberal arts undergraduate program and a three-year graduate professional program...should be the long-term goal."
- Accounting educators who are not CPAs should be permitted to take part in state CPA society and AICPA activities.

General Remarks

The Commission's introductory remarks state that many new accountants have found that their education did not adequately prepare them for the responsibilities they face upon entry into the profession, and that the firms (primarily the large firms) spend substantial sums on the entering professionals who have just been graduated. Formal education can rarely provide all the needs of a beginning professional whether he be a civil engineer who cannot build a road in his classroom or a lawyer whose mettle must be tested in the courtroom. The scientist may complete his formal education in the classroom and the laboratory, and readily transfer his educational process to industry, but accounting and auditing are not sciences. The auditor's studio is the business enterprise and the economic system, and the skills developed there must be translated and synthesized insofar as possible into the textbooks of formal education.

The fundamental problem between the practitioner and the educator has been created by a lack of understanding and agreement on which part of the educational process belongs with the educator in the classroom, and which part is best satisfied by the practicing professional. A clear sign that the professional believes the educator has satisfied his role is evidenced by the extreme competition to employ the best graduating students. The practitioner does not ignore what the educator has accomplished, but builds on it by continuing with his firm's educational professional development activities and programs.

The Adequacy of Educational Preparation for the Profession

The Commission asserts that "The public accounting profession has been unable to rely to the same extent as other professionals on formal education for the development of competence to practice (p. 85)." It is our position that the educational
process for the most part is being discharged in a satisfactory manner and that the additional education supplied by our firm adds that element which cannot be taught in the classroom.

The Commission also states "that accounting has not been given full professional status within the university by establishment of separate colleges such as those for law and medicine" -- thus presuming that the establishment of separate colleges is in fact needed. There are many arguments about the value of separate professional schools of accounting, and no unanimity can be found among either educators or practitioners. The myriad of issues is beyond the scope of our response, but just a few of our reasons for not favoring separate professional schools of accounting are given below:

1. The economics of higher education at the present time and for the foreseeable future make it doubtful that proper and sufficient financial support could be found within state governments or would be forthcoming from the profession for the establishment and expansion of separate professional schools or programs. This may also be true in many areas, including business, science, education, or the profession.

2. Some serious problems may result in obtaining academic support from faculty members in other disciplines e.g., arts, science, mathematics or other business areas necessary for the appropriate enhancement of accounting education.

3. There is a risk of developing a narrow-gauged accounting professional who may have concentrated excessive efforts and resources in accounting subjects to the exclusion or deemphasis of subjects required to educate the "whole man" -- those subjects in science, language and the arts.

4. There appears to be a greater need to improve the quality of education in the business schools than there is a need to change the structure of an educational institution, unit, or department.

5. There is already an excess of accounting students and students with graduate degrees. Yet there would not be enough qualified accounting professors to meet the projected demand of separate professional schools of accounting.

6. Professional programs in accountancy have not been articulated in a manner so as to enable appropriate dialogue among practitioners and educators. This is unfortunate, since it impedes analysis of what is needed and what roles the practitioner and the educator should have. Some open questions concerning professional schools of accounting include:

   a. Should the faculty be limited only to accounting professors?
b. Should practitioners be included as faculty members? If so, how many and in what ratio?

c. Would the proposed school be independent --
- of the business school dean?
- for budgetary purposes?
- from State Boards of Accounting?
- of state educational requirements for the CPA exam?
- to recruit faculty members who are not PhDs?

d. Would a separate physical building be required, as is the situation at most law schools today? Would the professional schools exist in name only and use facilities of the present business school?

e. Should it be strictly a graduate program, or might it also be an undergraduate program, or perhaps a Doctoral program?

7. If many separate Professional Schools of Accountancy are established throughout the country there will be little status. This would nullify one of the major supporting reasons and the schools could develop into "cram" courses to pass the CPA exam.

We realize that we have addressed above Professional Schools of Accountancy in general, rather than the precise long-term goal given by the Commission. There are enough points of convergence, however, that the exercise may be helpful in bringing out our points.

Status of Accounting Education in Schools of Business

In this section the Commission states: "In many business schools, particularly at the graduate level, this means that accounting is primarily a service subject in an environment that views education for business as education for business management." This statement may be true, but fails to recognize that for several decades, many of the leading national business schools have also offered "tracts," or majors, in accounting as part of the MBA program. In such programs, the student who concentrated or majored in accounting benefitted from working with senior faculty members having advanced degrees and considerable academic and often substantial practical experience. Touche Ross believes that the MBA graduate with an accounting major or an accounting tract is a better educated person fully qualified for an entry level position in the profession. If all schools were able to train the entry level
professional within the MBA programs now offered in these leading schools, our profession's entrants would compare favorably with, or perhaps exceed the preparation of, some entering the legal and medical professions.

In discussing the "Effect on Faculty," the Commission makes the statement that "The academic accounting community, which had a substantial concern with the profession and financial accounting in the 1930s, has moved in recent years principally to managerial accounting or financial analysis with a heavy mathematical emphasis." We are unaware of the facts underlying this statement. A cursory review of accounting faculty listings published by AVISO Publications for the 1976/1977 period indicates that a large majority of those who teach accounting teach financial accounting, not financial analysis. Mathematical analysis is also categorized in this publication, and the number of professors working in this area is certainly very small. Our experience indicates that most senior faculty members continue to be interested in the same financial accounting matters as the practicing professional, and that further, most of the senior faculty members at the major universities throughout the country are both PhDs and CPAs.

Touche Ross has been in a unique position of presenting seminars for professors on current financial accounting problems over the last ten years (presently called "The Trueblood Professors' Seminars"). We have thus had an opportunity to work with nearly a thousand accounting professors, and our observation is that there is a continuing intense interest in the financial accounting problems of the practicing professional accountant and not by any means a preoccupation with managerial accounting or mathematical quantitative analysis (which of course, does have its place in practice).

The Commission describes the "Effect on Students" this way: "Since education for business management has been the focus on business schools, prospective independent auditors receive their first exposure to the nature of their future duties in an environment closely identified with corporate management." This is an advantage -- CPAs have to understand business management to audit it! Other than the unsupported statements contained in the American Institute publications cited in footnote 1 on p. 86, there has been no researched evidence that students are biased towards business management and away from accounting and auditing areas because of the actions of business school programs. The evidence is overwhelming that superior students still pursue an accounting major, and of that group their first career choice is often that of the practicing professional accountant. The brighter student has not been deflected by the fact that accounting is not taught in a separate school; and as the Commission knows, many graduate students consider the outstanding and best career to be that of the practicing professional accountant.
As to "Effect on Research," the Report asserts (p. 86) that "Current problems of immediate concern to the practicing accountants have attracted little interest among academic researchers, and auditing -- which represents the bulk of public accounting practice today -- receives scant research attention in most business schools." Our general remarks at the outset of this section pointed out that the educator by choice was not in the mainstream of the business and economic system, thus disabling him from working in the business research "laboratory." Auditing research is significant if it is performed in the environment of the practicing professional. (8-1)

The accounting educator nevertheless has an opportunity to make a major contribution to accounting and auditing research if he does it in cooperation with the practicing professional. Educators are now making a contribution in the computer auditing and statistical areas, highly important subjects for auditors. We and other firms have offered significant professorial research opportunities in accounting and auditing, with the availability of the full resources of firms available. (8-2) Finally, we have in our employ at the present time a number of educators involved in research areas.

Thus, there is little evidence to support the Commission's statement that "The resulting influence on student career choice and the contribution of the academic research to improvement in practice has been less than is desirable." We recommend that the Commission publicize the data supporting its statement that a lack of research by the accounting educator has had an adverse influence on candidates for entry into our profession.

Lack of Professional Identity

"New entrants to the profession lack professional identity.... A program of learning imbedded in a school that views its mission primarily as educating the student for business management is unlikely to produce in him a highly developed sense of identity as a member of the public accounting profession (p. 86)." As in other professions identity develops as one practices. It is speculation that entry level work is more overwhelming to new accountants than to new JDs or MDs. The entry level accountant when out in practice benefits from exposure to others' diverse backgrounds and disciplines.

Those identity characteristics needed by the practicing professional come with practice in the real world. Nevertheless, some improvement could be made in the educator's environment, though this may require a significant change in the educational process for those intending to be accounting educators. More on this later.
Entry Level Training of the Professional Accountant

This subsection emphasizes that:

- Large firms spend great sums of money training entry level professional accountants, and the smaller firms must spend more on a per capita basis to provide similar training.

- To alleviate some of the training costs, smaller firms have joined together to receive training materials from the AICPA and other societies.

- Educational programs of the large firms are potent recruiting tools.

- The body of knowledge for accounting is growing at a dramatic rate, and keeping abreast of new developments is difficult.

- The response of formal educational programs to developing professional needs has been limited.

- Business schools have had little involvement in continuing education programs.

- Entry level training is slow on current problem uptake.

The implied oppression of the smaller firms is a somewhat specious consideration. Today's national firms were spending considerable sums on entry level training programs when they were as small as some of the smaller firms of today. In the case of Touche Ross, entry level training programs were offered 30 years ago when fewer than 50 persons were recruited for the entire firm from universities throughout the country. While many young men and women today are attracted to the larger firms because of their training programs it is our experience that graduate students do not make employment decisions based solely upon training programs. Rather, a controlling factor appears to be the variety of client experience offered by the larger firms. Advanced degree holders generally feel saturated with formal classroom education and are anxious to begin professional practice.

Many business schools have little involvement in continuing educational programs related to public accounting; the academic environment lacks the real life decision-making orientation. But many practitioners participate in the broader continuing educational programs known as "Management Development." It appears as if the practicing professional looks to reentry of the formal classroom environment for broadening his experience and outlook but not for more professional accounting training.

Touche Ross believes that more can be done to incorporate current problems in the entry level training in business schools. Our contributions, through our Professors' Seminar Program, of actual practice current case material is a step in this direction.
Continuing professional education in most disciplines is in its infancy and undoubtedly will grow. The Commission's seemingly negative assessment is, perhaps, unjustified.

Improving the Educational Process

Professional schools -- the long-term goal -- Touche Ross has already spoken out on the issue of professional schools. It is our preference that professional schools of accounting remain within schools of business and not be free standing; and earlier in this section we have enumerated arguments against professional schools of accounting as the regimen. Excerpts from our firm's brochure(8-3) further explain our reasoning:

"Our concern is to insure continued quality educational preparation for entry into the profession. It is our conviction that this quality education can continue to manifest itself within existing educational structures, or emerge as new programs within the school of business.

"The complexity of our environment need not be interpreted as requiring the development of one -- and only one -- specific educational program for professional accountants.

"In our view, quality educational preparation for the profession may occur:

. Within existing schools of business
. Through traditional accounting departments
. As a part of the professional program or a professional school within the school of business

Moreover, the preparation which is offered may be a four-year program, a five-year program, or an MBA or doctoral program. Each of these may be appropriate when examined as individual units and when tested by the demands of the profession.

"It is also our view that each school of business is best able to determine its structure, assess its administrative requirements, and allocate the resources required to meet its responsibility for quality accounting education. A school of business should not have to look to others who may seek to force changes which it may consider unsound for its particular circumstances. Thus, we believe it unnecessary for a school to obtain approval of its organizational structure or accreditation of its program from non-educational institutions. Each school of business must strive, in the way it believes best, for excellence in preparing students for entry into the profession.
"To support our concern for quality accounting education and to assist those schools of business which strive for excellence in preparing students for entry into the profession, we pledge a financial commitment of $1,000,000 to be disbursed over a five-year period.

"In addition to our financial commitment, we also pledge 1,000 days per year of partner time to be made available for projects as short as one day or programs as comprehensive as a partner in residence for a full semester. It is anticipated such time commitments will be used in on-campus activities for classroom teaching, seminar participation, independent assistance to students in honors or graduate programs, or in research projects."

The Commission has nevertheless concluded that graduate schools of accounting similar to law schools will instill in students an appropriate professional identity and expose them to the pressures and problems of public accounting practice during their formal education process.

It is undeniable that for students aspiring to the practice of accountancy this is a desirable goal. However, we are not convinced this can be done in a professional school of accountancy. Evidence that other professions, having separate schools, better educate to withstand the strains and pressures inherent in their professions, is also lacking.

The Commission's research shows that "Audit failures have not, for the most part, resulted from a lack of knowledge of accounting or auditing requirements." What more evidence is needed that educational preparation for the profession is not at fault? It is highly unlikely that skills in dealing with stress and poor judgment are teachable in the classroom, whether in a professional school or in the prevailing present system.

Professional Society Affiliation for Academics

An increasing number of teachers of accounting proceed directly through the educational process, unfortunately without a period of practice experience. It is our recommendation that a more cooperative effort between the practicing professional and the educator is needed: before the PhD degree is awarded, a reasonable period of time in the practicing profession should be required for the candidate. Cooperation between the educational institution and the firm in designing and executing a program which would provide the necessary professional experience for the PhD candidate is a goal deserving high priority. Touche Ross stands ready to cooperate with educational institutions in experimenting with the redesign of PhD programs to incorporate appropriate practical experience.

While it would be desirable for educators to belong to state CPA societies and to the AICPA, membership would not, in our view, significantly change the participation of academics in the
affairs of CPA societies. Nevertheless, we support the Commision's recommendation that the AICPA and state CPA societies develop a form of membership which would open membership to non-CPA accounting educators.

Uniform CPA Examination and Continuing Education

We concur in the Commission's plaudits for the uniform CPA examination, and point out that it is under continuous study and review. We also support the Commission's comments on continuing education.

Summary

Touche Ross does not agree with the long-term goal stated by the Commission that there should be "a four-year liberal arts undergraduate program and a three-year graduate professional program, similar to that of law." We have publicly stated our view in opposition to that of the AICPA and of another major accounting firm. While there may be special situations where professional schools are appropriate, in general the existing undergraduate and masters programs are more than adequate for the training that is feasible prior to entry into the public accounting profession.

Our concern is built on the premise that academic instruction cannot replicate "on the line" experience necessary for understanding auditors' responsibilities and objectives. If academic institutions could obtain the services of seasoned professionals as instructors, and if the student could be given "real time" experience, the additional years of education might pay off. But because the best professionals and the best opportunities will forever remain out in actual practice, they will not be transferable to classroom use.

An apprenticeship program would be useful, provided it could be with an organization that had a broad range of experience and versatility of professionals. We think the Commission has reacted favorably to the in-house educational programs of the major CPA firms and is desirous of transferring such programs to academia, to afford those intending to enter the profession, but not in the large firm circuit, the same opportunities. While the idea is commendable, we do not see how it can be practicably accomplished.

We believe improvements can be made in AICPA and state society courses designed to partially compensate for the "disadvantage" visited upon members of other than the major firms. At least the AICPA and state societies do obtain the services, as speakers, lecturers and discussion leaders, of many experienced large firm personnel, who seem very willing to give their time in this manner.
We are in favor of the AICPA and state societies creating an associate membership status to admit non-CPA accounting educators. The subject has been discussed before by the AICPA and should have been approved at an earlier date. It seems obvious that those teaching entrants to the public accounting profession should have access to, and be given, all of the information on current developments to assist them in proselytizing professional standards.
(8-1) Refer to our comments at page 10.6 -- regarding the desirability of focusing all auditing research -- academic and professional -- under a newly constituted Auditing Standards Board.

(8-2) Our philosophy is contained in a 1976 publication by the Touche Ross Foundation, entitled "The Touche Ross Program To Support Accounting Education."

(8-3) Ibid.
The Commission's Tentative Conclusions

- Auditors should decline any accounting advocacy engagement that may bias the audit function.
- Public accounting firms should avoid appearance of conflicts of interest by not engaging in employment recruiting or placement of individuals directly involved in selecting or retaining auditors.
- The audit committee should be aware of all services provided to a publicly held company by its independent auditor.
- Knowledge of a material deficiency in published unaudited financial information, acquired by the independent auditor in performing other services, must be recognized in persuading client rectification or disclosure.
- Knowledge gained from other services, including by consulting personnel who are made aware of the responsibilities of independent auditors, must be transmitted to, and its implications considered by, the audit partner in charge.
- Providing advice on appropriate accounting principles should not be extended to the point of advocacy.
- Public companies should, in proxy statements that call for auditor selection or ratification, describe other services provided by their auditors.
- Independent directors should recommend the appointment of auditors and evaluate the auditor/management relationship.
- Audit fees and timing should be considered by the audit committee in direct discussion with the audit partner.
- The type of disclosure in financial statements now required by the SEC concerning disagreements when a change in auditors occurs should be required for all audited financial statements.
- The auditor should not accept an engagement if permission for dialogue between old and new auditors is not granted.
- The audit committee should inspect the personnel rotation program of the independent auditor and evaluate its effectiveness.
- Time pressures have an overriding effect on the quality of the audit; there is a need for improved use in accounting firms of budgeting procedures, for evaluation of variances and in attitudes toward personnel ratings.
- "Individual public accounting firms should immediately undertake to conduct studies to determine the extent of conditions revealed by the Commission's (Survey of the Influence of ... the Auditors' Work Environment on Professional Performance) and the effects on their practices."
- Early earnings releases merit a stringent warning about the possibility of revision upon audit.
- Auditors should refuse to accede to annual report and 10-K deadline pressures when their judgment would suggest that audit thoroughness could suffer.
- Auditors must be consulted on registration statement deadlines and reject unrealistic impositions.
- The AICPA Ethics Division should consider the appropriateness of anticipating the recoupment during future audits of initial engagement fee shortfalls.
- All firms should develop carefully drawn limitations on gifts, discounts and special favors from clients.
**Introductory Remarks**

Independence is an extremely important topic, as the auditor has nothing to offer if he does not have his independence and objectivity -- the hallmarks of our profession. The Metcalf Staff devoted a considerable portion of its Study to describing the public accounting profession as not truly independent of its clients. Touche Ross has responded to the Metcalf Staff Study, and excerpts relating to independence are included in Appendix A, pages 2-5.

The Commission on Auditors' Responsibilities seems to have taken a totally different tack, however, approaching the question of independence substantially from the viewpoint of audit environment, policies of major CPA firms and time and fee pressures. It is imperative that this subject be thoroughly considered, and the Commission's perspective is perhaps a better approach for the auditor's understanding.

We have some disagreements with the Commission's commentary on professional deficiencies. We are worried that the impression given of the integrity of the public accounting profession may be unfairly critical. We therefore offer, for the Commission's reconsideration in preparing its final report, our remarks on those aspects of Section 9 which we think have the potential for focus and magnification by outsiders anxious for "documentation" of professional faults.

**Restriction of Services Incompatible with the Audit Function**

The Commission's summary conclusion (p. 92) states: "There is no evidence that provision of services other than auditing has actually impaired the independence of auditors. However, the belief of a significant minority of users that independence is impaired creates a major problem for the profession. Decisions on the other services offered and used should be made by individual public accounting firms and boards of directors of clients."

We concur in this conclusion, though we have several recommendations on the proper remedies for non-independent appearance.

- **Management Services**

  Although management advisory services provided to an audit client may have the appearance of being inconsistent with the auditing function, we are convinced that this is not the case with respect to those consulting services performed by Touche Ross, and probably by other large firms. In conducting our management advisory services we are careful to make a clear distinction between advising a client -- which requires objectivity and independence -- and making management decisions -- a role which is inconsistent with independence.
Apart from these safeguards, we have also found that performing management advisory services for an audit client tends to facilitate our ability to render our audit opinion because of the understanding about the company's business and procedures obtained in the course of that work. We already require coordination of all client services under a general services partner and have adopted certain specific requirements for interfunctional information exchange, cited later. Management services are discussed further in Appendix A, pages 2-4.

- Alleged Conflicts

We agree with the Commission's conclusion that the following alleged conflicts are not sustainable, and we offer further commentary:

. Reviews of a company's internal accounting procedures (Yale Express) cannot be a conflict, as the Commission calls for this as part of the continuing audit function, especially in connection with interim quarterly reviews and evaluations of internal controls.

. Comfort letters (National Student Marketing) are the placebo of underwriters, who quite rightly under SAS No. 1, Section 630 (SAP No. 48) must specify what procedures they wish to have the auditors perform. (9-1) We would not object to abolishing comfort letters especially if the auditor's function continuing throughout the year could be developed as a more desirable substitute.

. Design of new systems ("Wall Street Back Office Mess") is within an auditing firm's bailiwick (9-2) (assuming it has acquired the proper expertise in the industry or area). The knowledge needed to do an audit of the systems is a substantial part of the ability to design them.

. Advising on the accounting effect of prospective merger transactions (Westec) is a part of general accounting advisory services indispensable to clients in today's complex rule-oriented environment (more of this below). It is also necessitated by New York Stock Exchange "pooling letter" requirements. Involvement in arranging mergers and acquisitions is problematic and Touche Ross does not act in this capacity. (9-3) If accountants cannot operate in an "advise and consent" mode, then they cannot effectively operate only in a "consent" or "challenge" mode, which is their primary activity.
- Tax Services

We totally agree that tax services provided in an advocacy mode by public accounting firms does not in any way affect independence in the provision of audit function services. We have two observations:

. LIFO causes problems because of the conformity rules. That the SEC and IRS do not see this the same way is evident from the several ASRs and complementary Treasury Department releases in recent years. The SEC's attitude of concern over "acceptability for LIFO tax purposes," not necessarily prevailing for financial reporting despite conformity rules, is emphasized by the recent SuCrest case.(9-4)

. Staunch defense by auditors of their work papers evaluating adequacy of clients' tax accruals and provisions, but not nearly so strong a defense of information bearing directly on the content of returns, as amply demonstrated in the recent Johns-Manville case, underscores the symbiosis of auditing independence and tax service advocacy.

- Accounting advocacy engagements that may bias the audit function

The Commission presents a balanced view in arriving at its general conclusion that "Auditors should decline any engagement that may bias the audit function. Also in all advocacy engagements the auditor should exercise care to make it clear to users that his work and opinions are not presented in his capacity as independent auditor." We agree with the conclusion, believing, however, that it can only be applied on a case by case basis.

The Report mentions "testimony at regulated industry rate hearings" in the context of audit client advocacy, much as did the Metcalf Staff Study. We in Touche Ross are perhaps unique in that the great bulk of our rate work has been for the public sector, even though the firm does provide auditing services for some utilities and does occasionally represent utilities in rate cases. The firm has also handled substantial fact-finding assignments for federal regulatory agencies, such as an investigation of a significant segment of the telecommunications industry for the Federal Communications Commission. A current project -- reviewing for the Interstate Commerce Commission the costs of the Trans Alaska Pipeline System for the purpose of setting rates -- is discussed further in Appendix A, page 5.

We also point out the truism that once a regulatory agency finalizes its ruling, with or without the acceptance of an auditor's advocacy, the subsequent audit judgments will be independent because they can then be related to the objective regulations as adopted.
In summary, the Commission's general recommendation should be read only as a concern over appearance of non-independence, and not as a challenge to the auditor's integrity.

"Executive search services" -- The Commission states (p. 99) that "Public accounting firms should, however, take measures to avoid the appearance of conflicts of interest...(by not engaging) in employment recruiting or placement of individuals who would be directly involved in the decision to select or retain independent auditors." Although there is widespread agreement on the desirability of auditors being selected or retained on the advice of the audit committee, we realize that financial officers, controllers, and similar executives who may not be directors are very influential. Accordingly, we agree that executive search services necessarily may give an appearance of non-independence.

With respect to "placement" with clients of former employees of the accounting firm, we believe the former association has virtually no effect on the auditor's independent frame of mind in carrying out subsequent audits.(9-5) Whether the former employee is "working out" as a member of management will be much more apparent to his superiors than it will be to the auditor; further, the auditor's best interests would lie in an early identification of any managerial weaknesses in his former employees before his client's welfare can be adversely affected by poor performance. Insofar as placing "unwarranted reliance on the representations" of former employees is concerned, the auditor's personal knowledge of the former employee may in fact permit him to assess more reliably the extent to which such representations are valid.

Although the AICPA has consistently taken the position that executive search activities as a professional service to clients does not create a conflict of interests which would impair independence, our firm will accede to a profession-wide rule precluding firms from engaging in executive recruiting, including mere client accommodation efforts.

We have reached this conclusion because of allegations in the Metcalf Staff Study, described in Appendix A, page 4.

- No Fundamental Change is Necessary

We are pleased with the Commission's conclusion (p. 99) that "On balance, ... the relevant facts do not support a prohibition against any particular services that auditors are now permitted to offer." As we said in our response to the Metcalf Staff Study, substantial safeguards in our firm assure that we do not lose our objectivity and effectiveness either as independent auditors or as independent management consultants. Tax advocacy has long been understood as not an audit independence threat, and accounting advocacy engagements are carefully controlled. Our MAS activity is a separate function within the firm through which we advise our clients but do not make their management decisions.

9.7
The additional knowledge gained in the course of MAS, tax and audit advocacy engagements facilitates our audit work. To preclude auditing firms from these kinds of activities would in our view bring more harm than good to audits by hampering additional and valuable sources of audit information. Furthermore, given the expectation that auditors will ultimately become involved in broader services for society by relating to more subjective information such as forecasts, it makes eminent sense for auditors to assist their clients in all professional ways so long as independence in fact exists in the audit activity.

"Board and audit committee involvement" -- The Report recommends active participation of the board or audit committee as a way of lessening users' concerns about the potential conflicts of services besides auditing. The Commission states that boards of directors or audit committees of publicly held companies "should be aware of all the services provided to the company by the independent auditor (who) should take the lead in informing them of those services and their relationship, if any, to the audit function, the fees for those services, and ... that information acquired in ... these other services must be considered by the auditor in fulfilling his audit responsibilities."

Touche Ross since the mid-sixties has advocated the establishment of corporate audit committees as an effective step in assuring auditor independence. Such committees should be made responsible for ascertaining that the auditor's professional standards are met as to their company. Our firm has published several monographs and a film on this subject. We are now updating all of our earlier information, as we believe the time has come for audit committees to recognize the major responsibilities being thrust upon them, and for auditors to realize that it is necessary to have two-way communications with the audit committee, not just to heap information on them.

We believe audit committees have considerable responsibility to monitor the propriety of their corporation's activity, as well as to understand whether the auditors they have selected have performed adequately. While it may be difficult to obtain a sufficient number of audit committee members having the necessary skills and expertise to deal with all the contemporary complex issues, we see little choice but to proceed in that direction.

"Knowledge of deficient financial information" -- The Commission states (p. 100): "If information acquired in performing other services indicates a material deficiency in unaudited financial information issued by an audit client, the independent auditor should persuade the client to correct the information or, failing that, assure that the necessary disclosure is made." This recommendation complements the earlier recommendations that the auditor immediately extend his audit function to the other information in an annual report and to more formalized association with interim financial reporting.
There are often considerable difficulties in ascertaining what is a material deficiency. For instance, managements have the prerogative to explain information outside of the financial statements in formats different than that contained in the financials. For example, summarized financial information is commonly given elsewhere in the annual report, and the auditor's obligation is to ascertain that there is no inconsistency with the audited financial statements. However, standards for the proper summarization of data have not been promulgated and therefore the auditor is sometimes confused about whether an inconsistency exists.

Thus, we recommend that the auditing standards board, in cooperation with representatives of management and financial executive groups, delineate appropriate standards for financial information presented outside the financial statements, insofar as possible.

As to the prompt communication of interfunctional knowledge of a client's affairs, we believe all firms should adopt and publicize appropriate requirements. We have such understandings in our firm, formalized in the practice policy manuals of our three major functions -- auditing, tax and management services.

Knowledge from other services which could be important to the audit is, perhaps in terms of today's standards, even more crucial than that relating to unaudited data (above). The Commission recommends (p. 101): "Public accounting firms should establish policies and procedures to assure that knowledge gained from other services is made available to the partner in charge of the audit so that he can consider its implications for the audit function, including assuring that consulting personnel who are not CPAs are made aware of the public accounting firm's professional responsibility as independent auditors." We wholeheartedly agree with this recommendation, and have had this as a matter of firm policy for several years. We think the appropriate way to formalize this is the manner we have chosen -- making the audit partner in charge of the engagement inquire of those in charge of nonaudit services for audit clients, as to the nature of information they may have which bears on the audit function, being careful to assure "being on the same wave length" in communicating.

"Providing advice on accounting principles" -- We agree that professional guidance is needed on the circumspect advising of clients on accounting principles without assuming a role of advocacy or usurping management's prerogative. We believe the Commission might find, if it attempts a search, that at least several firms have semiformalized policies in this area that could be synthesized into a draft recommendation. We have statements of policy, for example, on

- Non-client requests for services,
- "Shopping" for accounting principles,
Regional and national technical consultation on these matters,

and we issue an annual detailed reminder of our audit role as amicable skeptics rather than as advocates.

"Proxy statement disclosure of other services" -- The Commission recommends (p. 101) that public companies disclose in proxy statements (that includes election or ratification of the selection of independent auditors(9-8)) "information on the nature of other services provided to the companies by their independent auditors." In our response to the Metcalf Staff Study, we emphasized how audit committees could assure that management services and other services in addition to auditing do not compromise the independence of the auditor. Accordingly, we do not agree that major non-audit services provided by auditing firms should be disclosed and described in proxy statements. Extremely minor items could be reported, and lengthy explanations would be necessary for users to be able to properly assimilate this information. And simply stating them would seem to raise an unnecessary "red flag." The Commission deals extensively with the issue of appearance of non-independence, and therefore we suggest deleting the recommendation of a practice that could aggravate that admittedly unfounded concern.

Protecting the Independent Auditor from Management Pressure

As to having "independent auditors approved, assigned or compensated by a government agency or to have audits conducted by a corps of government auditors" (p. 102), we absolutely agree with the Commission's rejection of such an approach. We and others responding to the Metcalf Staff Study believe we presented a strong case that structural changes of this nature are neither necessary nor warranted. We are not nearly so convinced that legislators and regulators see it the same way; we suggest the Commission in its final report emphasize its conclusion and be reiterative in stating its reasons.

The issue of who pays the auditors' fee is not the crucial factor, especially in view of the price competition referred to by the Commission on page 117.

"Audit committees and boards of directors" -- The Commission recommends (p. 103) that "Independent members of the Board of Directors should be responsible for recommending to shareholders the appointment of independent auditors and for evaluating the relationship between the auditor and management." We completely agree with this recommendation and we have, wherever possible, encouraged not only the formation of audit committees, but the need for an executive session of the auditors and outside members of the audit committee at each meeting. In this way audit committee members can evaluate the relationship with management without concern that the auditor will feel constrained in his responses.
There is no reason that the chief executive officer and the chief financial officer should not be present except during the executive session, as their input and discussion on complex matters will often be useful to the audit committee.

"Audit arrangements and fees" — The Report states (p. 104) that "Matters of fees and timing, in particular, should be carefully considered by the board or audit committee, in direct discussion with the audit partner." We agree that the audit committee should inquire into the adequacy of fees and the timing of audit work, in order to obtain frank assurance from the audit partner in charge that fee limitations if any did not affect audit scope (and therefore possibly its quality).(9-9) However, it may be unrealistic to expect the audit committee to fully evaluate fees, especially in major engagements; but the committee should be offered a summarization, on a comparative basis, of the auditor's charges. The auditor should also indicate what total time charges and expenses were on the engagement, how much "restriction" he has taken, and be prepared to explain the reasons why the restriction was advisable. Auditors are businessmen operating in a competitive environment, apart from their obligations to serve society. The auditor should generally know when inefficiencies occur in his audit, and be prepared to adjust his fees accordingly.

"Scrutiny of auditor changes" for disagreements — We agree that the type of disclosure called for by item 12 of Form 8-K of the SEC would probably be useful for all audited financial statements, but additional specification is required of what constitutes a disagreement and how its effects are measured for purposes of inclusion in subsequent financial statement disclosure.(9-10) We also suggest that, for companies not subject to the SEC, there be a formal letter from the client, when terminating the auditors' services, in which any disagreements of the type contemplated in ASR 165 are described, and an acknowledgement letter from the terminated auditor in which concurrence would be indicated or other explanation given.

Need for dialogue between changed auditors — There is little question that auditors who are not permitted access to the prior accountants will, in scrupulously observing professional standards, refuse to accept that engagement except in rare circumstances. Communications between auditors should cover more than the minimal matters required by SAS 7; this SAS should be revised to give additional and specific guidance on the nature of matters to be communicated: though dialogue should be required to include all significant matters, if the succeeded auditor has subjective, unresolved doubts(9-11) to convey to the succeeding auditor, provision should be made for the client to be present to explain his views on the matter. In some instances, auditors may have suspicions they are unwilling to divulge, perhaps on the advice of their own legal counsel, at the time they are resigning. This area surely needs further study for the adequate protection of the client and the new auditors, without placing the resigning auditor at serious legal risk for his commentary.
We also agree that disclosure of auditor changes should be included in the recommended report by management covered by the Commission on page 77.

"Rotation of auditors" -- As we have pointed out in our response to the Metcalf Staff Study, there is already intense and healthy competition, and we do not believe that mandatory rotation of auditing firms or placing two firms on the stockholder ballot would serve any useful purpose. In fact, such an approach could lead to even more concentration by taking away from smaller firms a portion of the public companies presently audited by them. Forced rotation would certainly increase total costs to society for the audit function, because of the increased incidence of start-up costs inevitable in first audit engagements.

We recognize the value of an auditing firm scheduling changes in personnel on specific engagements, to provide the substantial advantage of a fresh perspective and to help assure that the audit team would not become too familiar with the assignment, losing its sense of challenge. That fresh outlook would be available within the continuity of the historical perspective of the auditor-client relationship and the attendant familiarity with the client's operations.

Therefore, we agree with the recommendation of the Commission that there should be rotation within an individual firm of partners and staff assigned to audit engagements. And we agree that the audit committee should be required to monitor the audit firm's rotation plan, evaluate its effectiveness and only then consider whether selection of new auditors for a fresh viewpoint is required.

Management Policies and Procedures of Public Accounting Firms and Their Effect on Independence

Competition and independence

We agree that the user has no opportunity to evaluate audit quality differences (p. 107), if indeed there are that many in the audits of publicly held companies. Likewise, users do not have an opportunity to impact audit price except very indirectly. This is an appropriate reason for audit committees to pay attention to audit fees, audit scope, and the relationship of one to the other.

But the Commission states (p. 108) that if "purchasers of audit services are more conscious of price than quality, auditors will be tempted to compete on the basis of price and to make necessary adjustments in the extent of work performed." The unavoidable inference is that audit quality will suffer.

In our American economy, processes are continually revised (auditing is a process) to strive for optimum efficiency. As auditors become increasingly aware of valid societal needs, there is little doubt in our minds that appropriate procedures for efficiently fulfilling those needs will be devised or will evolve.

9.12
Although the potential for degrading of quality by excessive fee competition exists, the Commission should not overly suggest that quality is suffering. There is no evidence (not even in the Commission's Survey described later) that fee pressures result in substandard auditing any more so than price competition among auto makers produces substandard cars.

In our firm, even while faced with intensive price competition, we have added procedures (9-12) in recent years which have increased overall audit costs 5 to 7%. To ameliorate the effects of price competition we have recently adopted a conceptualized audit approach (9-13) which will result in eliminating vestigial audit procedures, trying to do only the work that "counts" and do it only once for however many purposes it is needed. Our Touche Ross Audit Process, while unique, is one of several such processes developed by major CPA firms. The amount of research and financial investment in such programs is immense, but our firm has been more than willing to undertake this investment in order to maintain and improve audit quality in the face of fee pressures.

As the Commission admits (p. 109), there is a need for large client base (the "critical mass") to support the costs of complex services and specialists. (9-14) The Commission's conclusion on fee structure will do nothing to change this phenomenon. Marginal cost pricing and building a core of clients in a particular specialized industry are both beneficial to society, as well as in the latter case, necessary to acquire the specialized industry knowledge the Commission has suggested in Section 4, page 39.

As the Commission is aware, the Metcalf Staff Study included the conclusion that "The size of the major firms permits them to dominate the profession and there should be more competition among them." Our summary view stated in response to the Staff Study is repeated below as it is equally appropriate to the Commission's deliberations (9-15):

"The Staff concludes that the large size of the Big 8 firms is at variance with the public interest. In fact, the exact opposite is true. Large multinational clients can only be handled by firms with the breadth of offices and specialized expertise adequate to the demands of those engagements. Further, a small accounting firm could have a significant independence problem with respect to a client which represented a dominant or substantial portion of its practice.

"The Study also states that the larger accounting firms are not sufficiently competitive to suit public need. ...That conclusion is simply not correct, which is undoubtedly attributable to a substantial misconception of the environment as it really exists. Actually, in few industries is there such an abundant number of strong,
aggressive competitors as in the accounting profession. This aggressiveness stems in large part from the firms' individual needs to grow in order to support the training and quality control demands of the business world which they serve as well as the increasing public expectations they are asked to meet."

In summary, we believe that firms are not limited by their ability to expand geographically or to enter new technical fields except to the extent they are unwilling to invest in additional personnel who possess the requisite characteristics and technical expertise. Our own firm is an indication of ability to grow, as we were formed since World War II and have achieved a position within the Big 8. Although we believe competition is intense today, we believe it to be healthy and reflective of the free marketplace.

With the Metcalf Staff believing there is insufficient competition and the Commission suggesting there is too much competition, this may be an indication that the nature of services and their quality -- and not competition -- are what's at issue.

The Overriding Effect of Time Pressures on the Quality of the Audit

We believe this is the most incisive portion of the Commission's Report, but we have concerns over some of its content. The Commission states its belief that, in general, audit failures are due to mistakes in judgment because of excessive reliance on client representations. But in searching for "the underlying cause of audit failures," the Commission seems to move away from the issue of excessive reliance by stating (p. 111) that: "Although there are other factors, the Commission believes that excessive time pressures are the most pervasive cause of audit failure." We believe the Commission could have been helpful in advising what the auditor should do when faced with representations extremely difficult to substantiate or perhaps not at all susceptible of external evidence. The extent of reliability of representations is a major problem, and one that has not been moved much nearer to resolution by the newly issued SAS No. 19, "Client Representations."

- The Commission's Survey of Audit Partners and Staff

Ever since we became aware of it in early 1976, we have paid careful attention to the Commission's "Survey on the Influence of Selected Aspects of the Auditors' Work Environment on Professional Performance of Certified Public Accountants" (often referred to as the "Rhode Survey"). Information is made available by the Commission in three strata:

- A more complete summarization by the Commission of the survey questions and results, along with conclusions drawn therefrom, in Appendix B, pages 167-174 of the Report.

- The entire 353 page research report by Professor John Grant Rhode, dated February 24, 1977, available for study only in the AICPA library.

We have reviewed all of these segments and have many thoughts on their content. We are willing to discuss our thoughts in personal conversations if the Commission so desires. We have the feeling, however, that the Commission understands our overall concern, as stated in the Summary section of this response (pp. vi-viii).

Therefore, we will generally restrict our remarks here to a few overriding matters:

1. The Survey most certainly was valid in purpose. Because it was substantially an attitudinal survey tolerating rather broad perceptions by respondents of what qualitative factors were implied in the questions, the Survey could not, of course, deliver factually on what its title implied ("Influence ... on Professional Performance"). However, the Commission described its purpose more aptly (p. 111) - "... to determine (auditors') attitudes and practices related to the quality of their work and independence."

2. In addition to asking respondents about their own performance, the Survey contained a number of questions about the respondents' perceptions of the performance of others. (We understand that ordinarily these questions are designed as validity checks.) There were significant differences between personal admissions and perceptions of others' activities in the area of "substandard" practices discussed on pp. 9.15 and 9.16).

3. The Commission undertook two other major endeavors relating to the effect of time pressures:

- A study to determine the underlying cause of substandard performance in selected cases involving auditors.

- A series of meetings with SEC enforcement staff and other SEC staff, and with selected technical partners of public accounting firms.

Accordingly, the Commission's conclusions are a synthesis of three sources, two of which were not by their nature subject to empirical constraints. The third, the Rhode Survey, appears to us to be statistically valid, but its design of questions could, in our view, produce many more inferences than those chosen by the Commission. This becomes clear upon study of and reflection on the entire research report.

9.15
4. The concerns identified by the Commission are real but we are worried that the Commission's identification of possible causes and the resulting recommendations could be viewed by the public as solid fact. It is our impression that this subsection of the Report could give a more negative depiction of auditors than is justified, especially when giving cognizance to the inferential range of the responses to the Rhode Survey.

5. The result of the Commission's treatment of this very important section of its Report could be, in our view:

- A misunderstanding by the public of the Rhode Survey, given its detailed content and its own recognition of inferential possibilities.

- A misunderstanding of the recommendation that firms conduct internal studies of the extent of unsatisfactory practices and conditions.

An element of publicity given to the Commission's Report is found in the column by Frederick Andrews on "Taxes and Accounting" in the Wall Street Journal on April 5, 1977. The column (full text is given at the end of this section of our response) notes:

"In total, of 1,441 responses to a question asking 'the primary motivating factor' for individual auditors to sign off on - or mark as completed - on a required audit step they actually had not carried out, 533 cited time budget pressures."

This is a fair reflection of the time and fee pressure statements made by the Commission in Section 9 and Appendix B of its Report. But we wonder if it is balanced, based on the following analysis we performed.

The synopsis quoted in the press is drawn from Question 35 of the Survey, which does not ask a respondent why he himself omitted a step; it simply asks for his opinion on why someone would do it. Although 40% cited time budget pressure, 23% felt the primary reason was immateriality of the step.

But more importantly, there were but 887 persons out of 1,526 respondents (58%) who admitted that they personally signed off on an audit step without completing the work. Of these only 52, or 3%, did so even though they were not satisfied with the extent of the examination in the particular area.

Why do more (1,441) have an opinion on causes of the impropriety than those (887) who admit to having performed it? The
answer may be found in Question 29 (perhaps a validity check question), which asks whether the respondent has ever known of others in his firm who were guilty of the impropriety. 1,182 respondents (or 73%) out of 1,630 said they knew of such conduct, and 20% said it occurred despite non-satisfaction with the audit of the area.

It has often been demonstrated that misconduct is alleged of colleagues much more so than it is of oneself (9-19), and that may partially explain the matter. Or it may leave some unanswered questions about the respondents' understanding of the Survey.

We have performed other cross comparisons and analyses of the Survey results, but we are certain that Commission members have also done so in arriving at a synthesis of the several information sources for this subsection. Further comments on our part might therefore seem presumptuous. But our view on a matter so critical to the profession as its integrity, is that no amount of detail could be too abundant in describing in the Report the information sources, their factual vs. opinion content and the broad range of possible inferences. However, we can appreciate that the Commission chose not to inundate its audience, and we therefore suggest on p. 9.19, an even briefer treatment of this subsection.

Comments on the Commission's conclusions and recommendations

1. We do not believe that unreasonable client time demands cause the auditor to compromise his independence. Because auditors perform a service, many will strive to perform it at the highest speed. In no way do they believe they are shortcutting the necessary procedures, and the Commission may underestimate the energies of dedicated professionals to both do it right and do it fast.

2. It is to be expected that surveyed auditors believe time budgets have an effect on auditors' performance. In most human endeavor, a time constraint causes a performance pressure, but such tension may be beneficial rather than detrimental.

3. In view of the belief of a large proportion of respondents that sign-offs without performance did not affect their audit satisfaction, what could have been conscientiously addressed by the Commission is the issue of appropriate and truthful documentation. (9-20) It stands to reason those work elements not affecting the quality of the audit could be regarded with expendability -- though we would not for a moment condone that approach.

4. We strongly agree that all time worked should be recorded by the auditor. Audit scope planning must be based upon full knowledge of previous time input. However, there are so many variables involved in ascertaining audit efficiency and competitive pricing that failure to record hours is but one element of the total problem.
Touche Ross has long had a policy requiring that personnel charge all time worked. No doubt some of our personnel who were included in the Commission's Survey may have answered that they did not always charge all their time. We consider this a serious problem, but one of internal administration rather than of quality control.

The practice of working additional hours without charging them also seems an anomalous response from individuals who may have admitted signing off for audit procedures without performing them. A high degree of professionalism in taking the time to complete the job properly, despite time pressures, is likely to be more important to most auditors than taking "shortcuts."

5. **A major factor involved in suppressing tendencies to sign-off audit procedures without performing them was indicated by Survey respondents as being the level of review in their practices. Touche Ross has had an in-depth "professional standards review" throughout its entire 30-year history.**

This independent preissuance review of the financial statements, auditors' report and audit work papers has, we hope, counterbalanced any significant tendency to shortcut audit procedures. Such a preissuance review procedure should be encouraged for all firms.

6. **The need for improved use of budgeting procedures in accounting firms --** Despite our differences of opinion over some of the Commission's comments about the adverse effects of budgeting practices(9-21), we agree that time budgets should be realistic. All of the purposes ascribed to time budgets stated on page 113 of the Commission's Report are valid. We have already included in our newly released conceptualized audit process a provision that time budgets and time expenditures be incorporated directly into the audit working papers. This was decided upon before the Commission released its Report, as conditions seemed propitious to adopt this step as a natural part of our firm's audit control evolution.

7. **The need for further study of audit staff members --** The Commission has recommended that "Individual public accounting firms immediately undertake to conduct studies to determine the extent of the conditions revealed by the Commission's study and the effects on their practices."

As the Commission is aware, SAS No. 4 requires that firms maintain an inspection program to monitor conformity with professional standards. All of the larger firms perform some type of periodic review of each office's practice quality. In our firm, a "Task Force Review" (in-depth
review of selected engagements) is alternated biennially with a "Technical Center Review" (a more limited coverage of overall quality aspects) so that each office has annual consideration of its professional standards compliance.

We believe this approach should be emphasized, but we wonder whether the Commission believes such programs are insufficient to minimize the occurrence of the problems revealed by the Survey. We hope the Commission did not have in mind a study of the integrity of a firm's professional staff as a means of ferreting out past defects, or to see if the Survey results are really as reported. It seems to us that the emphasis should be on high standards of conduct, with the admonition (based on the Commission's Survey results) that disregard of those standards should be summarily dealt with.
Firms which have not already done so would be well-advised to state a code of conduct in Staff Manuals issued to their employees so that there can be no misunderstanding that ethical standards take first prominence, far in excess of any considerations of meeting time budgets -- which, after all, are and should be only estimates in advance of encountering specific audit circumstances. We think that sufficient publicity of the Commission's concerns along with fortified internal inspection programs will be an adequate remedy.

* * * * *

We recommend that the Commission, in its final report, briefly restate its valid concerns and its recommendations. We suggest that causative factors be restudied by the Commission and those not supported by reasonably factual evidence be minimized or removed. We are certain the Commission's final report will receive very broad attention and it is important that this most sensitive area of integrity be dealt with in a way more favorable to the profession, to the fullest extent the Commission believes justified.

Time deadline pressures -- If the SEC were to adopt more flexible deadlines for 10-K reports, or if it were to adopt a continuous disclosure approach with varying auditor attestation dates, even though the company's fiscal year is not changed, this could alleviate time deadline pressures. Perhaps the initial action might be to convince the SEC to grant more extensions for 10-Ks. At present, it is difficult to obtain an extension.

Part of the answer must lie in the public accounting firm structuring itself to operate within existing time constraints. If it does not, the competition may be able to do so. This is a fact of professional life.

A matter we believe deserves attention more than the intended publication date of a company's annual report is the scheduling of board and audit committee meetings. The auditor should not meet with the audit committee until the financial statements are drafted, all major audit conclusions reached and the auditor is prepared to report. Audit committee scheduling should therefore remain more flexible.
Time pressures and registrations -- We do not understand the Commission's statement (p. 117) that "On some occasions, request for haste (in registration) may evolve into substantial time pressure, and, with some frequency, an audit failure." We are only aware of one situation where a registration time pressure caused a "failure." (9-22) We do not understand where the Commission obtained its view of "an almost excessive willingness of some auditors to be pressured in registrations." Specific cases would be instructive in the addressing of this issue by the profession. Finally, use of the phrase "to be pressured" is vague -- if it means that the audit firm is willing to do everything possible to be of service, but not to compromise its standards, that kind of pressure should be tolerable.

Of course, we agree that the auditor should not concede to excessive pressure to complete his work, and for that reason there should be adequate independent review of the engagement and of the decisions of the partner in charge.

Pricing practices and independence -- We, of course, agree with the AICPA ethics rulings concerning unpaid fees. A more formalized approach, however, should be taken to recoupment of first-year audit costs, to mitigate the problems which may be created by excessive price competition. While the major firms in general are willing to make it financially painless for companies to change auditors, and while we agree that first-year overruns should not be deemed a receivable, it would be well to deliberately recognize the need to absorb such costs in overall gross margin of public accounting firms, without preclusion of recoupment if subsequent auditing efficiencies occur.

The need to adopt policies on gifts and discount purchases from clients -- We totally agree with the Commission's recommendations. Our firm has long had a policy in its Administrative and Staff Manuals that gifts should not be accepted, and discount purchases from clients cannot be made unless there is an Executive Office approved plan applicable to the entire firm, offering no greater benefits than would be expected in view of the volume involved.
Footnotes to Section 9

(9-1) Many procedures "requested" by underwriters are somewhat standardized based on the content of SAP 48, or are formulated based on the accountant's profferings -- but they nevertheless remain the choice of the underwriter in fulfilling a part of his "due diligence."

(9-2) We note that the Commission's Survey of Audit Partners and Staff disclosed (p. 174) that only six percent of the respondents "had experienced resistance from supervisory audit personnel or 'felt reluctant to identify internal control weaknesses in a system adopted by the client as a result of consulting services provided' by their firm."

(9-3) The Commission might also point out that the AICPA Code of Ethics specifically precludes a member from assuming the role of management. The involvement in negotiations between the parties in a merger seems clearly a management role.

(9-4) In SEC v. SuCrest Corporation reported in SEC Litigation Release No. 77-, May 31, 1977, the SEC acted in relation to certain inventory transactions in which the LIFO vs. FIFO question was central. The Litigation Release states:

The Complaint alleged that SuCrest and Rionda had engaged in sham transactions when SuCrest orally agreed with Rionda to resell to Rionda after SuCrest's year-end the same quantity of raw sugar which SuCrest had purchased from Rionda prior to SuCrest's year-end at a price which would assure both companies of no monetary gain or loss between them, except for fees which SuCrest paid to Rionda. The Complaint alleged that these transactions materially affected SuCrest's year-end inventory quantities and the income computed therefrom for its fiscal 1975 and 1976 years, and resulted in the dissemination of false and misleading press releases stating SuCrest's income, and in the filing of false and misleading reports with the Commission. The Complaint further alleged that officers of both SuCrest and Rionda made materially false and misleading statements to SuCrest's auditors, S. D. Leidesdorf and Co. ("Leidesdorf") in order to conceal the existence of the oral agreement from Leidesdorf.

The Complaint further alleged that SuCrest generated false and misleading documents in order to give the appearance that certain raw sugar purchased by SuCrest should be accounted for under the First-in, First-out ("FIFO") accounting method, instead of under the Last-in, First-out ("LIFO") method of accounting, since the FIFO accounting treatment would have enabled SuCrest to report less earnings and thereby incur a correspondingly lower income tax liability.
The Commission's Survey of Audit Partners and Staff indicates (p. 174) that only four percent of the respondents "felt there was 'pressure from supervisors to accept the representations by former members of (their) CPA firm now employed by the client or from those individuals placed with a client following an executive search by (their) firm.'"
Our firm's policy (Technical Letter 149) requires the following:

"Inquire of Tax and MS personnel assigned to the client as to their knowledge of management involvement in material transactions.

"In a large majority of situations, our audit clients engage the services of our Tax function to prepare, or advise in connection with the preparation of, income tax returns. Also, client executives often engage our Tax Department to prepare their income tax returns. Accordingly, a direct inquiry must be made of the partner responsible for tax services to the client and its executives (or other tax personnel he designates as being knowledgeable with respect thereto) as to whether the Tax Department has found any evidence, not already known to the Audit function, concerning management involvement in material transactions. Recognizing that tax return preparation almost invariably postdates the audit completion, tax personnel should be asked to bring to the audit partner's attention relevant information arising after completion of the audit.

"If we provide management consulting services to the client, the partner responsible for such services (or others he designates as being knowledgeable with respect to those consulting engagements) should be asked whether, during the course of the consulting engagement, any information came to his attention concerning management involvement in material transactions which may not already be known to the Audit function."

Initially, we encountered some difficulties with Internal Revenue Code Section 7216, but we believe that that matter has been appropriately resolved.

Refer to our comments on Westec on page 9.5.

Why only in these proxy statements? Though we are not in favor of the Commission's recommendation, we can see only a SEC jurisdictional distinction, and not one justifiable conceptually.

The Commission states here that its "research suggests that time pressure generated by unduly low fees and by arbitrary deadlines are the most significant cause of substandard performance by auditors." (Emphasis added.) We are concerned over how such a statement is understood by the laity. This is covered in our discussion of the Commission's Survey on page 9.16.

(9-11) The Commission uses unresolved doubts as a trigger for resignation. Although we mildly challenge that (at p. 4.6 herein), we are certain that the Commission would not want the succeeding auditor oblivious to unresolved doubts.

(9-12) These were principally in the areas of "Management Involvement in Material Transactions" and the auditor's consideration of "Illegal Payments."

(9-13) The Touche Ross Audit Process can best be described as a logical, analytical method for determining the most efficient and effective approach to each audit engagement. It allows us to do three things:

1. Minimize the redundancies in audit procedures performed. (We have noticed that using the procedures taught in schools and widely applied in practice yields duplicate information.)

2. Identify the least costly (least time-consuming) of the valid alternative audit procedures for accomplishing each specific aspect of the audit.

3. Take better advantage of the statistical and other scientific auditing techniques we have developed.

When employing this process, we expect to shift a greater portion of our audit time from performing procedures to planning and analysis. The net effect of this shift will, in most cases, result in a reduced total audit time in that we more efficiently gather the same audit information we have always needed to make audit judgments. In addition, the potential is there for quality improvements.

Our approach is neither highly structured nor loosely structured. We have particularly stayed away from too much structure for some very important reasons. First, although a highly structured or "cookbook" approach is, in certain circumstances, easy to teach and to apply, in circumstances other than those anticipated by the approach, it will either be inefficient, or perhaps even fail. Second, the control over audit quality in other than anticipated circumstances is the auditor himself -- he must recognize in advance what to do. The highly structured approach limits the auditor's control over audit quality. It does no good to proceed down the wrong path and then discover that time and effort have been wasted.
Our experience has been (and this is also based on outside behavioral research) that the highly structured approach may encourage auditors to become "mechanistic" in their attitude and the performance of their work. Our philosophy is to motivate them in the opposite direction -- toward awareness and healthy skepticism.

Thus, our approach has a structure which establishes a logic process to the audit of each set of circumstances. We stay away from the use of forms, but we do document our plans, judgments and conclusions in a standard way. This assures that all critical judgments are made, and facilitates an effective review process.

(9-14) Displacement of smaller CPA firms because of price competition is questionable. Perhaps that phenomenon may be occurring in a few instances today, but we believe it has always been a fact that the large firms have reason to charge more because of their high central overhead.

(9-15) Our firm's detailed comments on "Concentration and Competition" are included in Appendix A, pages 5-8.

(9-16) We note the Commission's citation of an article concerning our firm which appeared in the Wall Street Journal on October 5, 1976: "Touche Ross Openly Strives for Growth as Accounting Firms Turn Competitive." It is unfortunate that this citation is included in a section in which the Commission describes its concerns over fees and other factors as causes of time and budget pressures; later in this Section, these "pressures" are transmuted into pernicious "audit failures."

A recognition of the content of that news article would have shown our strong view that, despite significant fee pressures and fee competition, there is pressure only to become more efficient in auditing, and not to reduce audit scope beyond what is required. No one denies there can be disagreement on how much testing is necessary in an audit or how much reliance may appropriately be placed on internal controls; but the Commission may have the unfounded concern that every minor audit procedure not performed, or procedure eliminated from the prior year's audit program, is an improper reduction in audit scope. A broader perspective would recognize that there are many vestigial audit procedures needing elimination, as they add little to the overall audit objectives. We believe that the countervailing problems of inflation and fee pressures are properly serving to produce more efficient audit approaches.
(9-17) The Commission appears to believe that time pressure influences the auditor to accept a representation too hastily. If that is the reasoning, a great deal more explication is needed.

(9-18) The Commission notes (p. 112) that "In some cases auditors were persuaded to give an opinion before the completion of what eventually turned out to be false transactions." This is only part of the problem. We realize it is difficult for the Commission to segregate all the features involved, but an extremely important feature is the state of the accounting art. An element of representations that needs to be dealt with is defining the "effective date of a transaction." The FASB plans to deal in a later phase of the Conceptual Framework with timing of recognition of an asset, liability, income or expense. They should be encouraged to do so more promptly.


(9-20) Documentation is, of course, important, as its absence or incompleteness has contributed to unfavorable results for accountants in problem cases which may not have been, in the final analysis, "audit failures."

(9-21) We agree with the Commission's statement of fact on page 114 that "problems of time budgets, as opposed to time pressure in general, would probably be revealed only by interviews of the staff involved..."

(9-22) The National Student Marketing registration statement problem was not an "audit failure," but as finally adjudicated, created a retroactive requirement that the audit firm had an obligation to disclose or see to the disclosure of its dissatisfaction in connection with unaudited statements.
Taxes & Accounting
Pressures on the Independent Auditor

By FREDERICK ANDREWS

Always and inevitably, the independent auditor gets off on the wrong foot concerning credibility. At first blush, the practice— as old as the public-accounting profession—of having the company being audited pay the auditor's fee seems to fly in the face of common sense. "He who pays the piper calls the tune," as the saying goes.

Closely supervised by a senior staff accountant, who is usually in his early 30's or younger. But the great bulk of audit checking is carried out by junior accountants, many straight from college.

According to Professor Seidler, the draft questionnaire on auditors' attitudes toward their work frightened the big firms with "a bunch of 'did you..."
The Commission's Tentative Conclusions

- The present Auditing Standards Executive Committee "should be replaced by a smaller full-time Auditing Standards Board..."
- The form of guidance provided by promulgated auditing standards should be changed to recognize auditor association with much newer information that will not be audited.
- There is a need for formal outside participation in the process of setting auditing standards.
- The Auditing Standards Board must somehow raise the unacceptable level of participation by many practicing members of the profession (the silent majority) in establishing auditing standards.
- The Auditing Standards Board should identify researchers competent in auditing and arrange for public accounting firm financial and practice-oriented assistance.
- Periodic reassessment of the Auditing Standards Board's operation should include consideration of desirability of publishing dissents.

The Critical Question: Who Should Set Auditing Standards?

Several years ago, the Wheat study group(10-1) concluded that accounting standards setting should not be performed by a government agency. The Commission on Auditors' Responsibilities believes this conclusion is even more persuasive in the area of auditing standards setting. We agree. There are many problems with the proposal that auditing standards should be developed and
established by the government. For example, the government, in necessarily responding to political pressures, would not act on the need for promulgation of auditing standards on a timely basis, would not be likely to attract the type of professional person capable of creating conceptually sound auditing standards, and has shown no evidence that it can do a better job than the private sector.

If the government were to establish auditing standards, political considerations would play too great a role in their development. Two cases out of many are discussed below.

- The first is the development of the Internal Revenue Code and its related regulations and revenue rulings. Since 1913, these have exponentially expanded to the point of incredible complexity. Many of these laws and regulations have little economic or conceptual accounting basis but were created to serve as economic development incentives. The net result, including court decisions and interpretations, is more corpulent than anything ever created by the accounting and auditing profession. The Internal Revenue Code is a bureaucracy which is cumbersome to administer and short on logic.

- The second situation is the government's intervention in accounting for the investment tax credit. In 1962 Congress established the investment tax credit as an incentive to business development in a then faltering economy. The Accounting Principles Board, using due process, concluded that the appropriate accounting was to spread the investment credit benefits over the useful lives of the assets which generated the credit. Those who desired to record the investment tax credit immediately as income lobbied and won. Congress legislated that no one could prescribe a single method of accounting for the investment tax credit, and the APB had to back down.

We believe that setting auditing standards is important enough to require the complete attention of those who are charged with its development. No governmental branch -- the SEC, the General Accounting Office, the Congress -- has the prerogative to solely concern itself with auditing standards. Since auditing would be only a part of their concerns, they could not be totally responsive on a timely basis. Even the SEC, most prominent among the outside influences of auditing standards setting, spends relatively little effort in the development of auditing, preferring to suggest needs and having others (such as AudSEC and individual firms) develop the ideas.

Nor can government attract, in our opinion, personnel of sufficiently high talent to create auditing standards. Only those are who are experienced in the auditing arena can reasonably set auditing standards. This experience is not obtainable in government service.
We believe that the process of establishing auditing standards must remain with those most qualified to determine these standards -- those who have had extensive practice as auditors. They must be able to deal with the problems of implementability of auditing standards -- a dimension of considerable importance.

The Present Process and Its Weaknesses

The accomplishments of the Auditing Standards Executive Committee and its predecessors are to be highly commended. In less than forty years the profession has created an impressive auditing heritage. Touche Ross & Co. has continuously participated in this process, expending substantial talent resources and money. We especially believe that the recent record of the Auditing Standards Executive Committee provides overwhelming evidence that the profession has acted with considerable responsibility in establishing high professional standards and procedures, responding well in emerging problems areas.

In less than three years, the Committee has issued 18 statements on auditing standards, as well as having authorized many interpretations and industry audit guides. These releases cover a wide spectrum of auditing issues, for example:

- SAS No. 4 is a landmark in auditing literature since it achieved specification on the quality control elements for all firms of independent auditors; any gaps in a firm's preexisting system were thus filled in. This statement has become the foundation for the profession's intensive peer review program being vigorously pursued by the AICPA.

- SAS No. 6 discusses accounting for related party transactions. This SAS, which took several years to develop, was issued in response to the critical litigation problems the profession faced in this area.

- Other SASs have expanded the role of the auditor to require his involvement with other information in documents containing audited financial statements and with unaudited data contained in financial statements, such as interim financial information and replacement cost data, and have dealt with communications between predecessor and successor auditors.

- SAS No. 12 deals with inquiries addressed to a client's lawyer and represents two years of debates with the legal profession over the conflict of privileged communication with the need for adequate financial statement disclosure of a mutual client's contingencies and uncertainties.

10.3
Recent SASs have discussed the independent auditor's responsibility for the detection of errors or irregularities and illegal acts by clients, perhaps greatly adding to auditors' responsibilities as well as legal liability exposure.

These accomplishments in establishing high professional standards have not come easily. The government, primarily through the SEC but of late by a covey of Congressional Committees and Subcommittees (10-3), has sought to attach new responsibilities to the auditing profession, without recognition of the limitlessness of current legal exposure.

On the other hand, more can be done. (10-4) The Auditing Standards Executive Committee is now composed of 20 part-time volunteer members, who can do little more than react deliberately -- not swiftly -- to problems as they arise. Thus there has been a somewhat random pattern to the development of auditing standards -- firefighting rather than forward, effective planning. Ideally the auditing standards setting process should also have a conceptual framework, in addition to envisioning emerging areas and acting on them before they ignite. We agree with the Commission that the process of setting auditing standards should operate more quickly and responsively to emerging needs. To accomplish this, the process must remain within the profession.

Recommended Changes in the Auditing Standards Setting Process

"A full time board" -- We have studied the Commission's recommendation that the Auditing Standards Executive Committee be replaced by a smaller auditing standards board composed of full-time members. (10-5) We agree with this proposal. We believe that the new board should consist of nine members since this number is small enough to operate effectively and efficiently, and large enough to provide an exchange of ideas among high caliber professional auditors. We believe that all members should be highly experienced professionals -- either from public accounting practice or from academia.

The auditing standards board should be empowered to issue statements on auditing standards on its own authority by affirmative vote of a single majority and without prior consultation with any other body -- substantially the same authority held by the Auditing Standards Executive Committee which requires a two thirds vote -- but within a continuing dialogue with the SEC.

We also believe, as a natural conclusion to self-regulation, that the auditing standards board should be part of the AICPA. We agree with the Commission's recommendation that a larger staff would be required to assist the proposed board. Self-regulation has its privileges and it also has its responsibilities. Since the profession is charged with its own self-regulation, it should support, through general membership dues, the salaries of the board members and staff and other operating expenses.
The term of board members should be three years, on a staggered basis. However, we believe that a board member should not be reappointable for an additional three-year period. This would assure a fresh insight in the standards setting process, and as to current problems. We also agree with the Commission that a board member may maintain arrangements to return to public accounting practice after his term. Independence is, of course, required of an auditor in his relationship with his clients. However, independence from his prior firm should not be required by a member of the auditing standards board. Indeed, these firms will be called upon by the board to contribute the talent of their senior people, and the firms themselves have a vital and unavoidably altruistic interest in the creation of workable auditing standards. It would not even concern us that a board member remained as a member of his firm, so long as his full-time efforts could be devoted to the board. However, appearances and administration would probably make this unworkable. In any event, arrangements to return to a firm will not, in our view, impair a member's objectivity; such a prerogative indeed may be necessary to ensure that highly qualified individuals will be eager to serve.

As a first step in establishing the auditing standards board, we propose that a review committee composed of representatives from the profession and other appropriate sectors be created promptly, study the matter in the manner recently done for the FASB by the FAF Structure Committee, (10-6) recruit the new board members, and determine that the board will be responsive to the needs of the public in establishing auditing standards. We envision that this review committee would be autonomous of the AICPA, but unlike the recent change in FAF composition rules, we think a majority of the review committee should be AICPA representatives.

We recognize that these proposals will require sacrifices of the profession. We believe, however, that a new auditing standards board will improve the process of establishing auditing standards and consequently the services which the profession can provide its clients and the public. We are ready to participate with the profession to implement a new auditing standards board.

"Form of guidance" -- As we have already suggested, there should be a statement of the "conceptual framework" of auditing, incorporating the independent auditor's role. Though much has been written on this subject (notably including the Commission's Report of Tentative Conclusions) the auditing standards board should develop its own version as a background against which to prepare future individual standards.

Needless to say, the Commission's recommendations on extensions of the auditor's role in Section 6 and his form of reporting in Section 7 would occasion considerable revisions in present standards on evidentiary matter and on reporting. We see no reason standards cannot be made to adapt if agreement is reached on the many fundamental changes envisioned by the Commission.
"Participation in the process of setting standards" — As much openness as is possible should be provided for, but there cannot be unlimited access if the board is to promulgate standards efficiently. Exploratory and developmental board sessions should probably be private, but all deliberative sessions should be "in the sunshine," open to the public. Of course, exposure drafts (even "discussion memoranda" where appropriate) should continue to be issued for public comment, and public hearings held on all proposed standards if there appears to be a sufficient public interest.

We have no suggestions on how to enkindle a desire on the part of the vast majority of practicing professionals to take the time necessary to comment on board proposals. We recognize the necessarily greater resources of the larger firms and their needs for homogeneity in their respective firms' practices will keep them involved.

Identifying researchers competent in auditing -- In recommending the establishment of a small full-time board to set auditing standards, particular emphasis is given to the lack of specific guidance in existing pronouncements and to the frequent problem of failure to pronounce on a timely basis. In Section 4 it was noted that auditors are not sufficiently aware of possible deficiencies in individual audit techniques and steps. Thus the Commission believes that more efficient and effective auditing research would assist the new auditing standards board in performing its tasks and avoiding the weaknesses of the present structure.

Touche Ross agrees with the Commission's position in general, but believes it does not go far enough. Our experience has been that significant improvements have been obtained in auditing through academic-type research. We see a cohesive effort as being potentially very beneficial to the profession, and believe that simply encouraging (or sponsoring) fragmented project effort tends to be counterproductive.

We believe that formation of the auditing standards board provides an opportunity to formalize auditing research on a profession-wide basis. The board, as the focal point for auditing research, could provide:

1. A taxonomy for auditing and auditing research.
2. A cataloguing of completed research -- e.g., through NAARS.
3. A data base facility for experimentation and teaching.
4. A vehicle for prioritizing research needs and communicating these as well as their results.

At the present time the large CPA firms support the idea of substantial audit research through the AICPA, joint ventures among themselves, internal projects, hiring of consultants and by academic grants. Many other groups are doing auditing research -- various
universities, the Institute of Internal Auditors and other countries' accounting organizations. If all of these could be brought together in a coordinated manner, the benefits in terms of efficiency and effectiveness could be tremendous. We believe the Commission should consider this potential and strengthen its recommendation accordingly.

**Periodic reassessment and operating procedure** -- We have already suggested establishment of a body to charter the auditing standards board. This body could be perpetuated much like the FAF Structure Committee to periodically reassess the board's effectiveness.

We would agree that dissents should not be published as part of the standards pronouncement, but they should be available for the public record so that those desiring more insight into interpretation of the standards may obtain it.
FOOTNOTES TO SECTION 10


(10-2) Refer to our footnote 2-10 c.

(10-3) Several of these instances (there are more) are current:

- "Report on Federal Regulation and Regulatory Reform," issued September 1976 by the House of Representatives Committee on Interstate and Foreign Commerce, Subcommittee on Oversight and Investigations, John E. Moss, Chairman (The "Moss Report").

- The Accounting Establishment: A Staff Study, prepared by the United States Senate Committee on Government Operations, Subcommittee on Reports, Accounting and Management, Lee Metcalf, Chairman (The "Metcalf Report").

- H.R. 3815, "The Unlawful Corporate Payments Act of 1977," sponsored by the Committee on Interstate and Foreign Commerce, Subcommittee on Consumer Protection and Finance, Bob Eckhardt, Chairman. This bill does not contain direct auditing requirements.

- S.305, "Foreign Corrupt Practices Act of 1977," a bill sponsored by the U.S. Senate Committee on Banking, Housing and Urban Affairs, William Proxmire, Chairman. This bill asks much of auditors.

(10-4) Our response to the Metcalf Staff Study, op. cit., stated (p. 8):

"As to auditing, ...the profession has been responding aggressively to legitimate increased public expectations and to the heightened challenges imposed by the increasing incidence of corporate fraud and improper corporate payments. Although we believe that the process of setting auditing standards could be made to operate more quickly and more responsively, we cannot agree that that function should not continue to be carried out within the public accounting profession, for only that group has the expertise necessary to perform the task. Moreover, the problems involved are apolitical in nature, so that the process need not be expanded to involve a broad spectrum of outside viewpoints and influences. This contrasts with the process of setting accounting principles, which merits participation of persons from inside and outside the profession because of the variety of callings in which expertise is available and the need to balance the elements of varying viewpoints and divergent self-interest."
"The tentative report of the Commission on Auditors' Responsibilities reveals an insight of the profession and makes a number of recommendations for improvement which merit attention. This is further evidence of the continuing efforts made by the profession to examine need for change. It appears clear to us in these circumstances that no significant purpose would be served in changing a system which continues to operate effectively."

(10-5) Suggestions have been made to retain AudSEC as a volunteer group, reducing or rotating the membership of the "Big Eight" firms. We are concerned that these are merely a palliative for governmental assertions of domination.

The Commission's Tentative Conclusions

- Public accounting firms should voluntarily expand public disclosures of their financial and other internal data if they foresee a sufficiently beneficial result.

- Once a duly constituted disciplinary body begins its work, those who initiate the ethics complaint should be informed of the status. After resolution, penalties should be well publicized. Excessive secrecy is wrong.

- Appeals in litigation should not delay disciplinary proceedings unless it can be demonstrated that the outcome would be prejudiced.

- The AICPA, with the cooperation of accounting firms..., should analyze cases as they move through the judicial or regulatory system.

- Legislation should be enacted empowering courts to assess costs against unsuccessful plaintiffs.

- Statutory limitation of monetary damages is essential to the continuation of the public accounting profession in the private sector.

- Increased use of masters is endorsed to make impartial expertise available to the courts.

- Safe harbors should be made available only when auditors are asked to assume new responsibilities or significantly extend old ones.
Protecting Users from Substandard Performance

The Commission makes a very important observation -- that substandard audits of entities not having financial difficulties are likely to go undetected. It is true that only a relatively small number of audits are alleged to be substandard; the allegation usually comes when financial or operating reverses occur and the financial statements, not having contained a clear prediction, are then said to have been improperly audited. And only in rare instances, does the auditor simply admit that he did not follow professional standards (or more likely "consent" without admission).

As indicated throughout the Commission's Report, the many judgmental areas as well as pressures involved in auditing would make it appear that, in most instances of management, their representations were false; and that in many fraud by situations of financial failure, the auditor may not have expressed a going concern qualification -- which the Commission proposes, and we agree, should be eliminated.

The fact that a few adjudicated cases have held the auditor to have not performed in conformity with generally accepted auditing standards (as those standards were precisely configured for purposes of that particular trial) should not be taken to suggest that there is a great deal of substandard auditing occurring which is not detected because the companies do not have financial difficulties. Even the results of the Commission's survey (Section 9), in which professional auditors have admitted to signing off for performance on audit steps not performed, showed down in its details that only 3% felt their omission occurred in such a way as to affect their audit quality in the particular area. Therefore, simply signing off on an unperformed procedure, while unprofessional in terms of documentation, does not cause a substandard audit. Even in some of the adjudicated cases of which we are aware, we think the auditing may have been better than was provable under challenge, simply because of poor documentation, and not because of unacceptable or subprofessional performance of the audit. While Touche Ross emphasizes the need for appropriate documentation, we must make the distinction here that the difference between a "standard" and "substandard" audit should be a conceptual one, based on procedures performed, rather than documentation amassed.

We concur in the Commission's view that the total system for protecting users from substandard performance, as it now exists, including litigation and actions by regulatory bodies, provides a reasonable level of protection to the public. If anything, we believe that the threat of litigation to the major firms provides an extremely strong impetus to following the highest professional standards out of an abundance of concern for later challenge. We comment on this later.

We realize, however, that the public, regulators and government may believe that the disciplinary and other forces are not sufficient, and that, therefore, improvements in the system should be implemented, as discussed below.

11.2
Influences on the Regulatory Mechanism

Under "Nature of Professional Practice," the Commission refers to "changes in standards and changes in performance." We think a distinction also needs to be made between "standards" and "procedures." The ten generally accepted auditing standards adopted by Council of the AICPA have been in existence for some 30 years. Although they are presently under scrutiny for change, they seem to be fundamentally acceptable, and need not be tampered with.

However, the procedures emanating from newly issued statements on auditing standards, as well as from other sources such as SEC sanctions and court decisions, take time to implement. That should not suggest, however, that auditors do not strive to perform according to standards at all times.

We wonder about the accuracy of the Commission's statement, in discussing "The Significance of Large Firms," that smaller practice units may not require the controls needed in large practice units to assure consistency of performance.(11-1) If all independent auditors are to operate according to the same professional standards, then all must control their performance in the same way. What the Commission may be referring to is administrative control, rather than technical quality control. Nonetheless, we agree that the larger firm, because of its dispersion, must have an extended span of control that small units need not have, such as professional development programs, in-house quality reviews, and other matters delineated in SAS No. 4, "Quality Control Considerations for a Firm of CPAs."

Practice Controls to Improve Performance and Assure Compliance With Standards

Voluntary public disclosure by CPA firms -- This section mentions, as a recent activity by public accounting firms, Arthur Andersen's publication of its annual report. Touche Ross & Co. has also published its "Report on Progress and Prospectives" over the last three years.(11-2) We believe we are appropriately limiting our remarks to essential information required by the public to understand the quality of our firm. Our response to the Metcalf Staff Study elaborates on this subject, and is included in Appendix A, pages 9 - 11. A summary of the public disclosures we think are appropriate is as follows:

- Size data - revenues, personnel counts
- Data concerning general scope of service
- Services to government agencies, and fees therefrom
. Financial strength data

. Data on quality assurance, research, training, staff
development and public interest programs

We are opposed to the issuance of full financial statements and
publishing earnings of individual partners. Privacy principles
should govern here, as no compelling reasons for disclosure can be
shown. Client listings are also unnecessary, as these are
available, as to public companies, from other sources.

Touche Ross will continue to make those disclosures
believed to be useful to the public, as recommended by the
Commission. We think, however, that this disclosure should
presently continue on a voluntary basis.

In its comments on "The Effectiveness of Practice
Controls," the Commission is correct in suggesting that individual
firms have intensified their activity in the area of quality
control(11-3) in response to highly publicized so-called audit
failures. While the Commission admits this is only a partial cause,
we submit that auditing quality control procedures have been rapidly
evolving, not because of failures, but because of the litigation
aspect -- the prospect of being unable to categorically demonstrate
to a lay jury that an audit was properly conducted in conformity
with generally accepted auditing standards.

We do agree, however, that additional attention, as
required in Section 9, should be given to CPA firms' practice
controls, primarily from the standpoint of improving efficiency and
quality, rather than to assess whether their present status may have
had a negative effect on the quality of work performed.(11-4)

Penalizing Substandard Performance and Misconduct

As the Commission is well aware, the Metcalf Staff
Study(11-5) made numerous allegations about the discipline of the
profession, to which we have responded at length. Because there is
a substantial congruity between the issues raised by the Commission
and the Staff Study, we have included in Appendix A hereof, pages
11 - 14, applicable excerpts of our response to the Staff Study.
Our views on the Commission's issues are summarized below:

- State Boards of Accountancy - Diffusion of responsibility
  into fifty separate administrative units produces
  inconsistent results. More effective use of these bodies
  warrants further study.

- The "secrecy" weakness - The Commission believes that
  existing secrecy has prevented their meaningful evaluation
  of the AICPA's disciplinary procedures. Initiators of
  ethics complaints are not informed of status, and
  resolutions are often described in the most general terms.
We suggest that consideration be given to lifting this "veil of secrecy" by:

a. The Joint Trial Board Division adopting a policy that upon a finding of guilty, a description of the violation of the Ethics Code, the name of the member and the punishment imposed normally be publicized.

b. Trial Board hearings be open to the public.

c. Those portions of the Ethics Division subcommittees and Executive Committee meetings that deal with non-disciplinary matters be open to the public.

d. Quarterly or semiannual consolidated statistics of ethics enforcement activity by the AICPA and State Societies participating in the Joint Ethics Enforcement Plan be publicized.

We do not believe that the complaining party should be informed of the status or disposition of ethics investigations for the following reasons:

a. To be equitable to all concerned, if the complaining party was informed of the status of the investigation then the respondent should also be informed as to who made the complaint against him. We believe this would reduce the number of complaints filed and thus be counterproductive.

b. Trial Boards are and should be the only body authorized to give publicity about a finding of guilty. Punishment such as administrative censures issued by the State Societies or the AICPA Ethics Division are private censures. Informing the complaining parties who in turn might inform others would turn these into public censures. If State Societies and the AICPA Ethics Division do not use administrative censures because they believe the violation warrants public censure, then the State Society or AICPA Ethics Division should recommend a Trial Board proceeding.

In an effort to coordinate enforcement and rule making, especially in the independence area, meetings with appropriate SEC and Ethics Division personnel should be held on a regularly scheduled basis.

- **Appeals in litigation** - Historically, action on alleged violations of professional ethics have been deferred if the member so requested it pending the outcome of litigation. The Commission's report calls for the member to submit detailed information that the purported ethical violations are directly related to the litigation before action on the investigation is deferred.

We believe that the relationship between the purported ethics violation and litigation, and the possibility of influencing the litigation by disciplinary proceedings has normally been self-evident. However, we have no objection to requiring the respondent to so demonstrate.

11.5
The same procedures would apply to matters on appeal -- that the respondent would have to demonstrate that the appeal proceeding could result in the introduction of new evidence and that the appeal process could be affected by disciplinary proceedings.

The Penalties of Litigation and Regulatory Enforcement

The largest single threat to the health and vitality of the accounting profession is the spectre of civil litigation. This subject is discussed in Appendix A, pages 14 - 15, and our summary (from pp. 6 - 7 of our Response to the Metcalf Staff Study) is cited here:

"The (Staff) Study, having assumed that audit failures are endemic to the profession, concludes that this results in major part from... deficiencies in regulatory and disciplinary procedures both within and without the profession. The Study suggests that such a problem could be alleviated by the SEC taking a stronger stand in disciplinary proceedings which involve the large firms and by enacting federal legislation which would increase the exposure of accountants to claims of private litigants.

"...the record does not support the conclusion that the number of audit failures which have occurred in recent years is indicative of pervasive professional failing. Nor is there evidence that the public would be well served by imposing on the profession a greater exposure to regulatory penalties and claims of litigants. The liability risks faced by the profession already constitute an awesome burden, and to suggest that those risks be extended would be counterproductive to attempts now being made (by the Commission on Auditors' Responsibilities) to encourage independent accountants to assume expanded duties to the public....

"The Staff Study concludes that the public sector can do a better, quicker, and more open job of... reviewing the quality aspects of auditing firms. It also states that such efforts would be carried on with less influence from self-interested parties than exists under present circumstances. Touche Ross agrees (as it always has) that the search for improvement of existing processes should be constant, but cannot accept the conclusion... that the public sector should assume the responsibility."

As a consequence of all this, and as the Commission suggests (p. 144), there is definitely an element of "wasteful, defensive auditing" which has built up in the last half dozen years in the auditing profession. We think this is mostly directed toward precision in documentation to assure that, if challenged, reliance will not have to be substantially on oral remarks of the persons who performed the work or made the judgment. In our own firm, we believe we may be excessive in comparison with other firms in terms of memo writing; although this practice has its origins in the distant past, our firm's proclivity toward putting memos on the file has accelerated in recent years, because of all the various and vague responsibilities being ascribed to the profession.
"Analyzing and reporting audit failures" - The Commission recommends (p. 145) that "...the AICPA, with the cooperation of accounting firms and through the use of court and SEC documents, should establish a mechanism for timely and continuing analyses of individual cases as they move through the judicial or regulatory system." Apart from the possibility that the Commission may be over-dignifying SEC proceedings as a source of changes in auditing standards (we believe the best way for standards and procedures changes to be mandated is directly, rather than indirectly such as through SEC homilies), this is an appropriate idea but considerable specification and safeguards will be required to make it work. The problems which will be encountered are similar to those involved in disciplinary proceedings (above) at the time litigation is in process.(11-6)

"Assessment of costs against unsuccessful plaintiffs" - We believe that appropriate legislation along the lines now being pursued by the American Law Institute should be enacted empowering, but not requiring, the court to assess costs against unsuccessful plaintiffs. This would tend to limit or discourage nuisance or strike suits against auditors.

"Statutory limitation of damages" - We are in favor of some form of statutory limitation of monetary damages which may be awarded in judgments against public accountants. Since the time devoted by a firm's senior personnel to defense is necessarily immense under current conditions, consideration should be given to appropriate recompense. Touche Ross is pleased to see the Commission in favor of limitations and is in general amenable to the American Law Institute's proposals incident to the restatement of the Federal Securities Code now in process.

"Safe harbors" - With respect to the Commission's recommendation that "safe harbors should be made available only when auditors are asked to assume new responsibilities or significantly extend old ones," we agree that this is one way to get auditors to step into experimental positions. However, it does not present a long term solution, and may have the disadvantage of taking a considerable time to formulate parameters before the auditors officially begin whatever it is. We suggest that, in addition, considerable recognition should be required to be given to statements by the auditor describing the limitations on the assurance he is giving in new areas. Presently there seems to be a reluctance to tread into new areas on the theory that all auditor's "caveats" will be dismissed as communication only for the initiated.
We are also concerned that the Commission may not have considered the use of "safe harbors" with respect to the many extensions of the auditor's role expressed throughout the Report. Although the specifying of forecasting and current values is made in the context of examples, there are many more "new, untried, high risk areas."

In a sense, all auditor assurances on soft or unaudited data would be in a "safe harbor" if sufficiently specific standards and objectives for the auditor's activity were to be created.
FOOTNOTES TO SECTION 11

(11-1) The Commission states that it has been unable to determine the effectiveness of large firm quality control systems, although they appear impressive. We trust this is not intended to create doubts. It could as easily be said that smaller practice units could be hampered because of the absence of these controls.

(11-2) The Commission's report footnotes the existence of the Touche Ross report without financial statements; this should not be taken to imply that financial data are required.

(11-3) Quality control procedures are also disciplinary, a fact not directly acknowledged by the Commission. ASR 153 required our firm, in connection with a disciplinary action, to install certain control procedures three years ahead of substantive adoption within the profession. In our case, the SEC used disciplinary action as a means of encouraging the creation of later SASs. In the case of Peat, Marwick, Mitchell & Co. (ASR 173), a somewhat controversial document concerning accounting for long-term contracts resulted. There could be further "quality control" influences from disciplinary actions in the future.

(11-4) Our comments on "Inspection of the Work of Auditors" in our response to the Metcalf Staff Study are contained in Appendix A, pp. 15 - 16.


(11-6) Refer to our comments on p. 4.8 regarding dissemination of information on frauds. This situation is much the same.
APPENDIX A
Applicable Excerpts from

STATEMENT
of
TOUCHE ROSS & CO.
for the record of hearings by
Subcommittee on Reports, Accounting
and Management
of the
UNITED STATES SENATE COMMITTEE
ON GOVERNMENTAL AFFAIRS
on
ACCOUNTING AND AUDITING PRACTICES AND PROCEDURES
May 23, 1977
EXCERPTS APPLICABLE TO SECTION 4. CLARIFYING RESPONSIBILITY FOR THE DETECTION OF FRAUD

Auditors Responsibility to Detect Fraud

The issue of auditors responsibility for protecting against such fraud arises only after the management and board of directors of a corporation have both failed in their primary responsibility for dealing fairly with shareholders and the public. Auditing failures have then later occurred, but only in the wake of a complete breakdown of corporate responsibility, which is a subject having vastly more direct impact on the public than does the role of the accounting profession alone.

An auditor's failure or inability to detect serious management fraud, at the outset, can result from a number of factors that need to be separately identified and treated:

- First, it can be the result of inherent limitations in audit procedures, which rely upon sampling techniques that, by definition, are vulnerable to undetected abuses. The assumption in the Study that an auditor could provide broad and unmitigated assurance of honest stewardship by corporate management is simply not valid within the constraints of economically feasible auditing procedures.

- Second, fraud which escapes audit detection by collusive deception on the part of management is necessarily coupled with deliberate misrepresentations and concealment. An audit is not the equivalent of an investigation designed to winnow truth from potential falsehoods, is not accomplished by subpoena power, and cannot be economically designed to presume that responses from management or confirmations from third parties are likely to be untrue.

- Third, undetected management fraud can be the result of an auditor's human failure. Although this can take the form of complicity, it is a matter of pride that of the thousands of persons active in the profession, only six have been convicted of criminal violations for auditing malfeasance in the past decade. If human failing is a significant and relevant problem, it is more likely a problem of deficiencies in such areas as qualifications, training, supervision, and diligence of performance. In our view, the adequacy or failure of professional self-discipline and outside regulation must be measured by determining the extent to which such deficiencies have contributed to instances where management fraud was not detected.
EXCERPTS APPLICABLE TO SECTION 9.
MAINTAINING THE INDEPENDENCE OF THE AUDITOR

Performance of Non-Accounting Management Advisory Services

The Study states that the performance of "non-accounting" management advisory services for audit clients is incompatible with the necessity of an auditor to be independent in appearance and in fact. Such non-accounting services are defined to include executive recruitment, marketing analysis, plant layout studies, product analysis, actuarial services, and financial management services.

As the Commission on Auditors' Responsibilities indicates in its Report of Tentative Conclusions, surveys of financial statement users generally show that a significant minority of users are initially concerned about the potential conflict between management advisory services and the audit function. However, their concern decreases as their familiarity with the nature of services offered by public accounting firms increases, and their concern diminishes further when the services are provided by different functional divisions of the staff, such as a separate management advisory services function.

As a general matter, substantial safeguards assure us that we do not lose our objectivity and effectiveness either as an independent auditor or as an independent management consultant. In the first place, our management advisory services activity is a separate function within the firm. Secondly, in our consulting work with clients we make a clear distinction between advising a client, which requires independence, and making management decisions for a client, a role which is inconsistent with independence. We are careful to act only in the capacity of independent advisors.

It has been our experience that the additional knowledge of a client gained in the course of management advisory service engagements facilitates our rendering an opinion as to the client's financial statements. Increased knowledge of an audit client has, in fact, been the objective of all good auditors going back to the time of the early Scottish accountants, who themselves also engaged in management advisory service work; to preclude auditing firms from consulting activities would accomplish little but to hamper an additional source of information. In addition, if the role of the auditor is to be expanded, as some suggest, to cover such things as forecasts, the necessity for even greater knowledge of the client is vital, and this could be supplied through the management consulting activity.

In any event, it appears that in spite of the merit of the above discussion, the Staff perceives that a potential problem of a lack of independence in appearance exists in the six areas of management advisory services work noted above, which we believe requires specific response.

- Marketing Analysis, Plant Layout Studies, and Product Analysis

As a first point, Touche Ross does not perform marketing analysis, plant layout studies or product analysis as those terms are defined in the Staff Study. This may appear inconsistent with our response to the letter from Senator Metcalf dated December 19, 1975, but only because we responded affirmatively to those particular questions out of an abundance of caution in dealing with undefined terms. Turning specifically to each of those issues:

1. Marketing analysis - The Study describes this term as “performing studies to determine the feasibility of selling a client’s products or services to a particular market...and may include identifying likely customers, surveying the attitudes of
consumers, or finding areas of excess disposable income.” The scope of our services in this area excludes any consumer research, and we do not perform engagements designed to discover areas of excess disposable income. However, we do assist our clients in determining whether contemplated major users of new products and services would view the new product or services as viable. In addition, we assist our clients in determining what channels of distribution are most appropriate and economic. Our services are limited to presenting our research to the client who, in turn, makes the ultimate management decision of whether to proceed with the marketing of the new goods or services.

2. Plant layout studies - The work contemplated by the Study requires broad engineering capabilities, which we do not possess and consider beyond our scope. In our prior affirmative response, we considered that the terms might include our inventory control work, which consists of assisting clients in achieving proper inventory levels and turnover.

3. Product analysis - We do not “analyze a client’s product to determine its value to customers,” as described in the Study. On the other hand, we do engage in product line analyses which employ well-established economic and managerial accounting techniques in order to assist clients in determining the relative profitability of existing product lines.

We do not consider the work which we do as described in items 2 and 3 to be in conflict with our audit function. Indeed, they consist merely of well-accepted accounting tools being made available for management’s use in its own day-to-day operations.

- Actuarial Services

Touche Ross is indirectly engaged in performing actuarial services through a joint venture arrangement with a firm of actuaries; such joint venture is not under Touche Ross management but is supervised by its own separate board of directors. We consider such work a necessity as part of our auditing services since generally accepted auditing standards as promulgated by the AICPA and SEC require that the auditor either be satisfied with the actuarial assumptions reflected in financial statements or modify his opinion appropriately. For example, in the case of an audit of a life insurance company (where actuarial assumptions as to required reserves would be a very material consideration), inability to be so satisfied would require the auditor to disclaim an opinion.

Because of this substantial responsibility in our auditing role, we have chosen to associate with a highly respected actuarial firm for expert assistance. We believe such a relationship is essential. We also make available to our clients the services of that separately managed joint venture for other specific needs of the client as, for example, the development of employee benefit plans.

- Financial Management Services

We perform work described in the Study as “financial management services,” specifically including such indicated services as “designing and implementing electronic data processing and other services which help management of client companies make financial decisions..., computer forecasting models and inventory control systems ....” These services relate to advising clients in developing proper financial records, accounting controls, and forecasting procedures, all of which are fundamental to reliable corporate accounting systems. The highest degree of expertise on this subject must by definition be available within independent accounting and auditing firms, and the assistance provided serves to improve the client’s systems and procedures for developing proper records, controls, and abilities to make ac-
counting and financial decisions. This activity is not in conflict with the firm's function of auditing financial results, but is clearly supportive of the audit function because of the heightened reliability of underlying systems which is produced. It seems clear that to prohibit accounting firms from providing such expert service would be directly contrary to the public interest.

- Executive Recruitment

The Staff appears to believe that to help a client fill a position is so conducive to a relationship which is other than arms length that independence would be compromised. Although we do not believe that such activities impair a firm's independence, we agree that auditing firms should not be in the business of executive recruiting, or purport to be. On the other hand, we believe that it is proper for a firm to accommodate the occasional requests of clients to assist in filling vacancies in positions where we have professional expertise. Clients naturally expect us to be able to help in filling their technical accounting and financial personnel needs, and we comply with such requests when we can.

On the other hand, we would be willing to accede to a rule, if universally applicable, which would preclude firms from engaging in any executive recruiting activity, including mere client accommodation efforts.

We believe that the concerns of the staff about non-accounting management advisory services can be met by corporate audit committees. As discussed earlier, such committees should be responsible for oversight of auditor independence, and thus should be alert to any possible problems arising from consulting work provided by the auditing firm.

Direct or Indirect Representation of Clients' Interests

Before Governmental Agencies

The Study asserts broadly that Big 8 accounting firms actively represent clients before federal, state and local governments and that they advocate the interests of clients on substantive issues regarding corporate taxation, pricing, government contract costing rules, federal regulations on corporate reporting, and uniformity of accounting for federal purposes.

Touche Ross does, of course, represent identified clients before such governmental agencies as the SEC, IRS, state tax agencies, and utility regulatory commissions, but only if the position taken is consistent with a totally objective viewpoint of the issues involved. We consider this activity a necessary part of our professional engagements and believe that we could not fulfill our professional duties to our clients in any other way. Touche Ross also occasionally makes its position known to legislative and regulatory agencies on technical issues or matters of principle, which the firm as a group of informed individuals believes is its right and duty as a citizen body. On the other hand, the firm considers it inappropriate to attempt to influence legislative or regulatory bodies simply to satisfy specific interests of particular clients. Such an activity would not be practical in any event, since the interest of one client is often diametrically opposed to that of another.

The Study states that Touche Ross "is very active in testifying before state regulatory commissions in utility rate cases," and we concur in that statement. However, the Study then asserts: "As such, it has supported controversial rate-making procedures which benefit utilities at the expense of consumers." That statement is incorrect. In our submission of April 30, 1976 to the Subcommittee we listed 71 instances in which we appeared before a governmental unit in order to offer testimony. In all but six of the engagements we were hired by a regulatory commission and in no instance did we testify on behalf of a public utility. As that suggests, the vast majority of our work in regulated industries is performed for regulatory bodies, public advocates, and municipalities which intervene in rate cases on their own behalf.
Our public utility services clearly meet the test of serving the public interest. Our work has faced unique challenges, as it is often contested by the public utility involved and judged by a state regulatory commission. In addition, we have been engaged by several federal regulatory bodies such as the Federal Communications Commission and the Interstate Commerce Commission. As an example we are presently engaged by the Interstate Commerce Commission in a project to review the costs of the Trans-Alaska Pipeline system for purposes of setting rates.

In short, for the Staff to imply that our work involving rate-making procedures primarily benefits utilities at the expense of consumers is wrong. A host of state and federal regulatory bodies will verify this position.

* * * * *

CONCENTRATION AND COMPETITION

The Staff has made the following recommendations concerning competitive aspects of the profession:

Federal action is needed to relieve excessive concentration in the supply of auditing and accounting services. (Recommendation 12)

Competition among accounting firms should be increased as to the auditor selection process, e.g., there should be (1) mandatory rotation of auditors after a certain number of years or upon a finding of non-independent action; or (2) placement of more than one firm on the ballot at annual meetings of stockholders. (Recommendation 4)

It is our view that both of these recommendations are based upon invalid premises and accordingly are inappropriate. Specifically, we perceive that (1) present concentration in the large firms is not excessive but rather is essential to the proper rendition of accounting and auditing services in the public interest, and (2) open competition among the accounting firms not only exists but has indeed become very intense.

Development of Existing Concentration

The configuration of firms and individual practitioners comprising the public accounting profession today is radically changed from that which existed at the end of World War II. Although most of the major firms existed then, their geographic coverage, both internationally and domestically, and their divergence in relative size were substantially less than at the present time. The profession consisted of more equally-sized firms that often operated out of a single location or on a regional basis, since the major U.S. corporations of that era typically were involved in a single industry at a limited number of domestic locations. Since commercial air travel was in its infancy, work away from office locations was often handled by correspondent firms. Regulatory requirements were much less complex at that time, as well.

During the fifties and sixties business became increasingly complex as the drive for corporate growth gave rise to mergers that took major companies into multiple industries and multiple operating locations. These new locations were frequently in foreign countries, each with its own set of regulatory requirements and tax laws.

Accounting problems became correspondingly complicated, as did state, federal and international laws respecting such matters as income taxes and securities transactions. As these developments occurred, auditing firms were required either to expand their operating locations and professional capabilities both nationally and internationally or face the prospect of losing their clients to firms better postured to provide the necessary services. Accordingly, firms responded by forming offices in more and more cities, often accomplishing this through mergers with local and regional accounting firms. In addition, they began to invest substantially in recruiting, training, technical resources, and quality control procedures. The process of
responding to needs imposed by corporate growth and increased technical complexity has continued throughout this entire era, resulting in a number of firms of international dimension, with large staffs providing expertise in a great variety of specialized fields.

**Existing Concentration in the Public Interest**

Only a major multinational accounting firm can maintain the number of world-wide locations required to audit large complex businesses effectively and on a timely basis, and avoid the problems of control and the waste of duplicatory effort which would inevitably be involved if several small firms attempted to service an engagement jointly. Only the combined talents found in a large firm can supply the varied expertise which would simultaneously be needed on a very large audit to cover such matters as special industry accounting, tax and regulatory matters, pension and profit sharing plans, state, local and international tax rules, safety and health regulations, and currency exchange rules. Only such a firm can stay abreast of the totality of an increasingly complicated set of generally accepted accounting principles, since many are applicable only to major corporate entities.

Specialists in the large firms are often the same professionals who also do much of the research on present and prospective accounting or auditing issues necessary to move the profession forward into the future. Normally this same research is shared with smaller practitioners through the larger firms’ participation in AICPA activities in the form of the development and distribution of technical materials, teaching in training programs, and service on AICPA committees. Such individuals in large firms also share their expertise with the profession at large through the publication of books and articles, as well as by giving speeches and participating in seminars on industry and professional matters. The same large firms are also better able to provide the financial resources which must constantly be reinvested in programs necessary to assure that their professionals are properly trained and that quality work is performed.

In addition, size is important for independence reasons. It is clear that where one or two major clients represent a significant portion of a firm’s fees, the firm will have greater difficulty maintaining its independence, given technical disagreements. That problem can only be cured through the existence of firms of sufficient size to serve a number of large corporations simultaneously. As a matter of fact, effective independent audits of sizeable companies are still available to its public shareholders only in those countries where large public accounting firms practice. Recognizing this, governments of several major countries where firms of substantial size have not historically operated have recently openly encouraged their formation. In other words, those countries have recognized that the lack of availability of adequate and independent auditing capability is clearly not in the public interest.

**Development of Competition Among Accounting Firms**

The need to maintain multiple office locations, a variety of specialists, extensive training programs, quality control systems, and other forms of fixed costs necessary to properly audit the major corporations in turn began to create pressures for added fee volume to cover those overhead costs. During the late fifties and sixties most of the firms were able to obtain this added volume in a variety of ways, since that was an era of unparalleled economic growth. The stock market was in its “high flying, go-go” years. New companies and conglomerates were forming at unprecedented rates, resulting in the need for a record number of SEC registrations. Much of this work went to the Big 8 firms because underwriters demanded that audit opinions come from firms with requisite experience.

It was also a period of substantially increased needs from several industries because of new regulatory requirements and demands of improved financial disclosure. These changes were particularly noticeable in the commercial banking, life insurance, and savings and loan industries, as well as in the health care industry where, with the advent of Medicaid and
Medicare, hospitals started requiring a totally new level of services from the accounting profession.

In government, other new programs such as the war on organized crime, welfare aid to mothers with dependent children, and low-income housing were created; old programs grew larger as the federal government became more involved in trying to solve the nation's social problems. Each of these efforts also created new requirements for accounting and auditing services.

During the late sixties and the early seventies, however, circumstances changed. The economy began to experience difficulties in sustaining its growth pattern as inflation and recession simultaneously developed. The stock market began to reflect extreme investor uncertainty, with the result that requirements for assistance in filing SEC registration statements fell to levels considerably below earlier periods. In addition, only a few new government programs such as Economic Stabilization and the Employee Retirement Income Security Act have created new service opportunities for the profession. In general, the period has been one in which the market for new services has become relatively inelastic. At the same time the requirements necessary to perform proper audits of companies have continued to escalate, increasing the overhead costs of the firms and requiring continued growth to support those costs.

This phenomenon has resulted in greater competition among the Big 8 firms for added volume. Since new areas for expansion are now relatively limited, it has meant that heavier competitive pressures have been placed on existing auditor relationships. We believe this competitive pressure is in the public interest. Others are concerned that perhaps it has gone too far. Tentative conclusions of the Commission on Auditors' Responsibilities state: "It is not lack of competition, however, but possible excessive competition that appears to present a problem to the accounting profession today."  

This competition has given rise to business development and client service programs within most of the major firms, designed both to obtain new clients and better serve existing clients. Today it is common for companies that are seeking to change auditors to discuss this matter with more than one firm and ask for competitive proposals before making a decision. Except in those states where precluded by statute, the proposal is normally required to include a fee estimate, which encourages competitive pricing. Although the potential client normally considers price important, we find that other factors such as the general reputation of the firm, qualifications of the professionals to be assigned to the account, understanding of the industry in which the company operates, and unique approaches to performing a quality examination on a timely basis are usually the more important factors upon which the selection is made.

Contrary to stated claims, such competition has not had a uniformly negative effect on the non-Big 8 firms. It is true that over the years the smaller firms have tended to be replaced on their larger multinational accounts by the Big 8 firms but only because those firms have generally been unable to provide a world-wide service capability economically. A continuation of such firms' attempts to audit a company which they are not postured to serve would not be in the public interest.

A close scrutiny of changes in auditors for SEC-registered companies during the past few years indicates that, except for the larger, more complex multinational companies, non-Big 8 firms have realized net increases in clients. For example, during the period from 1973 to 1976, there were 1,379 completed changes in audit relationships for SEC-registered companies with sales volumes of $25 million or less. The net effect of these changes was that the Big 8 firms as a group lost 132 clients to non-Big 8 firms — hardly a situation that would occur if the smaller firms were not able to compete effectively in an overall sense.

Another concern sometimes raised is that Big 8 concentration has in fact limited new competition. The successful rise of Touche Ross to a position within the Big 8, following its formation since World War II, is the best proof we can offer to dispel this concern. We believe
that firms are not limited by their ability to expand geographically or to enter new technical fields except to the extent they are unwilling to invest in additional personnel who possess the requisite personal characteristics and technical expertise to provide high quality professional services. Such investments are relatively small compared to industries, such as petrochemicals or steel, where significant outlays for plant and equipment would be required. The building of many new important segments of our practice, including agribusiness, construction, and health care, were started through making these long-range investments. Such expertise and part of our client base were often initially acquired through merger, as well as by bringing other individuals with specialized knowledge directly into the firm.

In our opinion, concentration has not lessened competition but, in fact, the need for individual firms to grow has been the very thing that has fostered competition. Although competition is intense today, we believe it to be healthy and reflective of the free marketplace which has been the foundation of this country’s economic growth. Contrary to often-stated claims, we do not believe it has caused the demise of the non-Big 8 firms, as they compete very creditably in the segment of the market they are best equipped to serve. And, finally, concentration has not limited new competition, to which the vigorous growth of our own firm will clearly testify.
EXCERPTS APPLICABLE TO SECTION 11. REGULATING
THE PROFESSION TO MAINTAIN THE QUALITY OF AUDIT PRACTICE

FINANCIAL DISCLOSURE BY THE 15 LARGEST FIRMS

The Study recommends that the 15 largest accounting firms be required to report annually on
basic operational and financial data and on various internal programs and activities, on the
grounds that the public needs such information to evaluate the performance of important
responsibilities under the federal securities laws. (Recommendation 9)

Touche Ross Annual Report

Through the publication over the last three years of our annual Report on Progress and
Perspectives, Touche Ross has met many of the concerns raised by the Staff. We have provided
a significant amount of operating data in these reports, including revenues, partners’ con­
tributed capital and retained earnings, mix of services, and number of partners and staff. In
addition, descriptions of our program designed to assure the quality of our services, programs for
the development of our professionals, and our research and public service activities have been
included. In this way, we believe we have been responsive to the Staff’s concerns about the
public’s right to know how Touche Ross is reacting to its responsibilities in the performance of
services and in our relationships to clients and the investing community.

Generally stated, our position is that we should be completely responsive to real and
appropriate public concerns about our firm. Where we believe there is not a demonstrated
problem or sufficient concern to justify the disclosure of specific data, we consider the possible
harmful effects to the partnership and its partners which could arise from public reporting. In
other words, we believe we should publish financial and operating data and descriptions of
various activities when we believe there is a demonstrated public purpose served by disclosure;
when it cannot be clearly shown that disclosure of other data is in the public interest, we
believe fundamental privacy principles should prevail.24

Appropriate Public Requirements

The Staff identifies a number of specific categories of data which it perceives the public
requires. Touche Ross believes that most of these are appropriate requests, and responds as
follows to the individual items:

• Size data (revenues, number of partners and staff), to meet a concern for a potential
concentration problem.
  Although we disagree with the premise that a concentration problem exists,
we do publish (as previously stated) such data in our annual report.

• Listing of clients, necessary to reveal unreasonable industry representation or exces­
sive dependence on a few clients or on an industry.
  This information is already available as to public companies through various
sources,25 and we believe need not also be reported by individual firms.

• Data concerning general scope of service, to reveal unwarranted scope or too much
concentration (similar to product line reporting requirements).
  We do not object to making this information available and in fact publish
data about our functional mix of services in our annual report.

• Types of service provided to, and fees received from, government agencies, to
provide data on involvement in governmental activities.
  This information can be furnished; we do not object to providing such
information, within the limits of professional confidentiality restraints.
• Financial strength data (with particular reference to a balance sheet), to provide a basis for assessing stability and to answer to legal judgments.
  
  Our firm has disclosed various facts about our financial stability in our annual report. In addition we annually provide balance sheets to banks from which we have lines of credit.

• Information concerning certain other activities, including quality assurance programs, research activities, training and staff development programs, and public interest activities.
  
  Descriptions and relevant quantifiable data can provide meaningful information to the public and we have accordingly described many of our programs in our annual report. Also, the AICPA peer review program, to which we are a party, is structured to review and evaluate many of these activities on behalf of the public.

Full Financial Statements & Earnings of Individual Partners

On the other hand, we do not support the Staff's recommendation that the large firms be required to issue to the public full financial statements and earnings of individual partners. The large accounting firms are all partnerships, are not publicly-owned, and are not open to public ownership. Accordingly, financial disclosure need be made only to partners and not to unknown potential public investors.

In addition, the staff has not demonstrated relevance to the public need of full financial statement disclosures by the major firms or the beneficial purposes for which such information would be used. Until a significant need to know can be demonstrated, privacy principles should govern, since Congressional and regulatory traditions and precedents would ordinarily not require public disclosure of full financial statements of non-publicly-owned organizations. Many, if not all, of the reasons for disclosure of information set forth by the Staff can be readily met through alternative limited means of disclosure specifically responsive to the need-to-know reason, as discussed previously.

Not only has the public need for general financial disclosure not been established, we believe that the publication of financial information relating to size, profits, rate of growth, rate of profitability, and rate of growth of profitability would result in performance pressures which would work to the public detriment. Such pressures could lead to:

• Short-cutting the scope of audits, resulting in performance deficiencies;
• Undesirable broadening of range of services;
• Less time and money spent on quality control programs, research, and training; and
• Increased concentration in the largest, most profitable firms as prospective clients use such financial information in selecting auditors (the ability of small firms to compete might be significantly impacted).

As to individual partner earnings, the Staff has not shown why disclosure of such data is relevant to the issues raised in the Study. It is difficult to understand the Staff's described need for partner compensation data in assessing a firm's performance, independence or influence on the establishment of accounting principles. Particularly, when dealing with individual partner earnings, public disclosure is a very serious invasion of privacy and, absent compelling reasons for disclosure, privacy principles should govern.

Experimentation with Voluntary Disclosure

In considering the issue of financial disclosure by accounting firms, the preliminary report of the Commission on Auditors' Responsibilities encourages experimentation with reporting on a voluntary basis, but without suggesting the precise nature of the data to be disclosed or the format of presentation. The report states:
"Our encouragement of experimentation with public disclosure is not a call for required reporting. Accounting firms are privately owned organizations. While there is interest in and possible benefit from information published by public accounting firms, there appears to be no overriding public need for it. Only when the public interest clearly mandates disclosure of information by privately owned businesses should public disclosure of their internal affairs be required. If public accounting firms foresee sufficient benefits to themselves, to the profession, and to the public, they should voluntarily expand their disclosures.""26

We support the Commission's position and believe that disclosures made in our firm's annual report comply with its recommendations.

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DISCIPLINE OF THE PROFESSION

Following are specific recommendations contained in the Staff Study:

The SEC should treat all independent auditors equally in disciplinary enforcement proceedings under the Federal Securities Acts. (Recommendation 14)

Congress should amend the Federal Securities Acts to enable damaged individuals to sue independent auditors for mere negligence. (Recommendation 3)

The federal government should not establish any "accountant-client privilege " or provisions which would limit the liability of independent auditors. (Recommendation 3)

The basic question raised by these recommendations is whether or not significant auditing failures have resulted from any deficiencies in the existing regulatory and self-disciplining procedures affecting the accounting profession. We believe it is necessary to examine this question in a broad context in order to reach meaningful conclusions.

Background of Procedures

The regulatory and self-disciplining procedures which concern the accounting profession are a complex pattern of interrelated factors, as the Commission on Auditors' Responsibilities has described:

"The system of regulation of the public accounting profession includes four elements:

- Establishing high standards of skill and competence for both entering the profession and continuing the right to practice.
- Developing and promulgating technical and ethical standards that serve both as performance goals and as a means of measuring departures.
- Designing and implementing quality control policies and procedures to monitor and encourage compliance with technical and ethical standards.
- An effective disciplinary system to impose penalties for performance or conduct that departs from standards established by law, SEC regulation, or the profession.

The overall effectiveness of regulation depends on the satisfactory performance of all four elements operating and interacting as a system."

The described interrelationship of these elements is a clear indication of the elaborate framework by which the profession attempts to assure high standards of performance.
Our present interest is with the fourth factor, namely, professional discipline. This, in turn, involves numerous components for the accountant:

- Disciplinary activities of the SEC;
- Disciplinary powers of state boards of accountancy;
- Ethics enforcement activities of the AICPA; and
- The threat and incidence of civil and criminal litigation.

Each one of these components has a substantial impact upon the current accounting scene, and has a substantial effect on each of the other three components.

Having identified the procedures covered by the general topic of discipline in the accounting profession, it is also necessary to give preliminary attention to the concept of "auditing failures" on which the Staff relies in its proposals for change. We have already noted in this document that the list of such "failures" is very meager in length and substance, in contrast with the thousands of audits performed each year with respect to public companies alone, and is related primarily to instances involving management fraud successfully perpetrated for some period of time before discovery.

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Specific Disciplinary Systems

We turn now to an evaluation of the four previously discussed primary sources of disciplinary authority within the profession.

- SEC Enforcement Program

The SEC has exercised disciplinary authority over the accounting profession under its Rule 2(e), which purports to empower the Commission to disqualify, temporarily or permanently, an accountant from practicing before it. Related rules define "practice" to include the rendering of opinions on financial statements of public companies, which is by far the most important phase of most large accounting firms' operations. Thus, the authority claimed by the SEC under Rule 2(e) provides, in effect, ultimate control over the right of a large firm and its individual members to engage in their professional pursuit. Statistics recently released for the first time by the SEC indicate that since it adopted this rule in the late thirties, approximately 115 professionals (75 attorneys and 40 accountants) have been the subject of disciplinary proceedings, either by negotiated sanctions or adverse determinations by the Commission following its investigation. This indicates the Commission has certainly been willing to exercise its Rule 2(e) authority.

We also note that while the Staff assumes that the SEC is lax in its discipline of the accounting profession, responsible commentators have begun to suggest that the SEC is over-zealous in its disciplinary attitudes toward the professionals who practice before it.

In its recommendations, the Study limits its criticism of the SEC's enforcement program to the assertion that the SEC deals more harshly with smaller practice units than with the large national firms. Since Rule 2(e) proceedings have generally not been public (except as to announced results when adverse to the professional), it is difficult for an outsider to evaluate that statement.

It is significant, however, that the SEC has consistently declared that its enforcement philosophy is designed to stimulate training standards and quality control procedures that will effectively protect the public. The SEC has also stated that, generally speaking, the large practice units have highly developed training and quality control procedures which obviate the need for SEC intervention, while the smaller units are sometimes found lacking in ways that require mandatory improvements following disciplinary proceedings. As a result, it seems appropriate to find
that the sanctions imposed by the SEC often apply firm-wide to smaller units to stimulate necessary improvements, while adverse findings against the large firms follow from individual or isolated departures from existing firm standards which warrant less generalized sanctions. The SEC has also indicated that in problems involving smaller units, all partners may be found to have shared responsibility with respect to a single audit engagement, thus requiring a sweeping disciplinary action. However, in the case of larger firms, the mass of partners who would be innocent of any wrong-doing or even involvement in a challenged audit could not fairly be curtailed of their professional rights to practice.

- AICPA Ethics Enforcement Procedures

The Study effectively summarized the ethics enforcement activities of the AICPA, as coordinated with the 39 state CPA societies which participate in the Joint Enforcement Plan previously described.* The Study also correctly notes that AICPA or state society authority is limited to determination of membership in the relevant organization. While this sanction would not preclude an individual from practicing public accountancy, the public notice of a membership termination is rightly feared as a major impediment in a professional career.

Although statistics regarding the overall disciplinary activity of the AICPA and the state societies have not been available prior to 1970, it is clear that numerous CPAs are under investigation at any given time. While many proceedings are concluded with formal reprimands and censures rather than terminations of membership, those findings are of substantial concern to the individuals involved and constitute part of their permanent professional records. The profession clearly respects the career damage that can result from these adverse findings and considers the AICPA and state society programs to be a significant disciplinary threat.

It is equally important to note the interrelationship between these disciplinary proceedings and related undertakings by the SEC, by state boards, and civil litigants. The AICPA program is the only one of these four disciplinary activities that has recognized pendency of other proceedings as a proper basis for deferring immediate activity of its own. The AICPA has concluded, and we strongly concur, that multiple attacks upon the same professional engagement can distort, rather than produce, meaningful results. The possibility that an accountant’s response in one forum of investigation could cause unpredictable consequence in the proceedings affecting

* That description is as follows:

Since August 1, 1975, a Joint Enforcement Plan between the AICPA and state CPA societies has been in effect for enforcing the Professional Code of Ethics, including the rule on independence. To date, 39 states have joined the plan, and five are in the process of doing so. Enforcement actions under the Joint Plan are taken in both the AICPA and state society’s names, and the results can affect an accountant’s membership in both organizations. Punishment can range from a private letter of criticism to public censure and expulsion from membership in both organizations, with publication of the matter being made to the 130,000 members of the AICPA and the membership of the applicable state society. Letters of criticism and certain other forms of censure may be issued by the AICPA or state society ethics committees, but suspension or expulsion requires a formal Trial Board hearing similar in many ways to a court proceeding. In any event, any of these steps taken publicly can be very damaging to the reputation of the offending CPA.
the same auditing services naturally tends to hinder our ability to deal candidly and effectively with legitimate authority. Accordingly, we are reluctant to participate in investigations by the AICPA which would have the effect of making experts of other professionals who might then be subpoenaed by plaintiffs in civil cases or by the SEC in related proceedings.

- **State Boards of Accountancy**

  The traditional source of ultimate disciplinary responsibility for the accounting profession has been the various state boards of accountancy. Each of the fifty states has such a board which is charged with the responsibility for licensing and disciplining accountants practicing in that jurisdiction. This authority historically preceded all of the other systems discussed in this section and has the clearest constitutional and statutory legitimacy.

  It is also clear that state boards of accountancy have not been highly active in applying those powers, although a growing level of activity is visible in recent years, including in a number of states the development of specialized staffs charged with such disciplinary responsibility. It is also recognized that diffusion of responsibility into fifty separate administrative units operating under slightly varying statutory mandates inevitably produces inconsistent results. However, these observations do not necessarily mean that these bodies are an anachronism or incapable of filling a valuable role in giving public assurance of quality services by the accounting profession. The potential for the more effective use of these bodies warrants further study and consideration.

- **Civil Litigation**

  The largest single threat to the health and vitality of accountants and accounting firms in today's environment is the spectre of civil litigation. Reasonable estimates suggest that many hundreds of such cases are currently pending, some seeking astronomical recoveries. It should be no surprise that these cases cover a breadth of criticism ranging from sheer opportunism by plaintiffs and their counsel to legitimate attacks upon the quality of professional performance. Case results cover a similar spectrum — from totally successful defenses by accountants, to occasional adverse judgments. But as with all kinds of litigation, settlements are the most prevalent form of resolution.

  No meaningful bona fide data are available with respect to the profession’s collective experience in the civil court. We can, however, impart some flavor by discussing the experiences of Touche Ross in this context. We have been the target of dozens of lawsuits in recent years, a level which we deem typical of national accounting firms. None of those cases involves any charges of criminal violations. Two civil suits have been tried to conclusion before a jury, both resulting in judgments wholly exonerating Touche Ross. One case is presently in trial, and others are expected to follow in the coming months. We have settled a number of lawsuits during the past several years, but our combined contributions to those settlements represent less than 1% of the amounts claimed by the parties who filed suit against us. In reviewing this experience to date, we are proud of the firm's ability to justify its professional services in the testing ground of civil litigation.

  The litigation horizon is not, however, free from trauma. The possibility of massive damage awards by juries composed of lay people who are not fully able to comprehend the complex commercial and professional issues involved is a fear that will remain with us for the foreseeable future. Furthermore, the demands of time and expense upon a national firm in dealing with its litigation portfolio are immense,
representing a percentage of our annual budget that would prove beyond the means of most commercial firms. The ability of the accounting profession to absorb this burden is based, in part, upon the availability of insurance protection which in itself is merely a financing device to spread costs over a period of time. Unfortunately, that protection is rapidly eroding.

Commentators have suggested that the volume of litigation is indicative of performance failures by the profession. We disagree. More than anything else, the volume of litigation indicates the recognition that accounting firms can represent a deep pocket when the principal corporate wrongdoers are insolvent or missing.

There is also a serious question in a broad social sense whether the measure of ultimate recovery to injured plaintiffs justifies the expenditure of time and effort involved in the total litigation effort. For example, the Commission on Auditors' Responsibilities estimates that 75% of the money that changes hands in these civil lawsuits is absorbed in litigation costs and attorneys' fees.\textsuperscript{10}

Some persons have stated that the threat of serious civil litigation serves a useful purpose by spurring the accounting profession to accelerate its attention to quality control and professional responsibility. However, whatever value these threats may have had has passed its optimum point and is now inevitably producing the counter-productive effect of impeding the profession from taking on new and creative responsibilities in serving the public interests. For this reason we must disagree with the Staff recommendations that the federal securities laws be amended to provide that auditors may be sued for mere negligence and that there should be no federally-established accountant-client privilege or limitation on auditor liability. These recommendations are based on the premise that exposure of auditors to legal liability should be increased. However, the potential for damage claims by public investors against auditors is already staggering, and any further burdens on the profession by way of opening additional areas of exposure would be counter-productive to the pursuit of professional performance, and would not be in the public interest.

\textbf{Inspection of the Work of Auditors}

We believe that the Study is correct in perceiving the need for an external inspection program of firms engaged in auditing publicly-owned corporations. Such firms constitute a substantial factor in the capital market and the public has a right to expect that the quality of their practice is subjected to the scrutiny of objective reviewers.

On the other hand, the profession has already taken steps to develop an effective inspection program. The AICPA has established several committees to develop the concept of peer review and has expended substantial money and talent in this quest. Two of these committees — the Quality Control Review Committee and the Special Committee on Proposed Standards for Quality Control Policies and Procedures — are currently active in developing the administrative structure, the conceptual framework and specific procedural guidelines for peer review. Many task forces have been established to assist the work of the committees in various detailed aspects of their work. The AICPA has published a "Voluntary Quality Control Review Program for CPA firms," and a guide to implementation of peer review is currently in the final approval stages.

The entire peer review program is scheduled to be operative at an early date, possibly in 1978. As presently envisioned by the AICPA the program would contemplate that all firms, regardless of size, may volunteer for a review by another firm or by a team established either by the Quality Control Committee or by a state society. The Quality Review Control Committee would supervise the activities of the teams and review the reports on individual inspections.
We believe that the ultimate development and implementation of such a program will effectively satisfy the public need, as opposed to the Staff's recommendation that such a function be fulfilled by the federal government. Professional auditors can be effectively reviewed only by others currently engaged in public practice, since only they would have sufficient breadth and depth of commercial, economic, and business experience, and the exposure to the multifaceted aspects of an accounting firm, to formulate an opinion as to its adherence to the standards of the profession. Furthermore, our opinion would not change if a review were not in the ordinary course but was ordered as a result of a disciplinary or enforcement proceeding required by the SEC, since the necessary expertise would be lacking in persons outside the profession, whether they be in government, industry or education. In addition, the AICPA has the professional credentials to manage the inspection program and to insure that professionals of high calibre and experience would participate.

Touche Ross has had an internal quality assurance program for many years. This includes a “professional standards review” function in each office, which entails a pre-issuance examination by a person independent of the engagement as to each audit report to be issued. In addition, a “second partner” is assigned to provide a further review of all major engagements. Each office is examined every year by seasoned partners and managers from other locations, with particular reference to internal quality control procedures and technical performance. Such deficiencies as might be noted in these reviews require specific corrective action by the office, and common deficiencies are reported to the firm through our communication system and stressed in educational programs.

In acknowledging the need for an external inspection program, the firm has committed a significant amount of time and talent to the AICPA in its current development of the peer review program. The firm has also arranged for a peer review of its own U.S. practice, which is being performed this spring and summer by another major firm.
FOOTNOTES


8 Ibid., p. 106.

24 Privacy Act of 1974 (Title 5, United States Code, Sec. 552a). In the introduction to Sec. 2(a), the Congress specifically determined that:....
   (4) the right to privacy is a personal and fundamental right protected by the Constitution of the United States; and
   (5) in order to protect the privacy of individuals identified in information systems maintained by Federal agencies, it is necessary and proper for the Congress to regulate the collection, maintenance, use, and dissemination of information by such agencies.

25 Such as Spencer Phelps Harris, Who Audits America; A Directory – 8000 Companies & 800 Accounting Firms (Menlo Park, California, 1976), and Auditor Extract Tape, (Bethesda, Maryland: Disclosure, Incorporated, 1976).


9 Ibid., p. 135.

10 Ibid., p. 144.