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CHANGING TIMES FOR CORPORATIONS AND THEIR AUDITORS

by

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CHANGING TIMES FOR CORPORATIONS AND THEIR AUDITORS

The public accounting profession has come under heavy attack in recent times because of the perceptions of its critics and the emerging recognition, particularly in Congress, of the importance of the role of auditors and financial reporting. The criticisms of the profession are lending to profound changes, especially in the role and responsibilities of auditors. Because the ultimate objective of these changes is to provide improved corporate accountability they will have a significant impact on corporate management as well. Therefore my remarks are relevant to the interests of the various groups represented here this evening. Understandably, however, I shall be talking mainly from the viewpoint of the independent auditor.

To place the recent developments in perspective let me give you a brief overview of why the profession has come under such heavy criticism.

Auditors have traditionally been looked to as a principal means of providing a reasonable degree of assurance as to the reliability of financial statements to help protect investors and credit grantors from being misled by misrepresentations or frauds. More recently, however, the function has taken on added dimensions because government officials have come to realize that:

1. Financial statements underlie the financial data and statistics which are used in the

formation of national policies, particularly those relating to the economy and capital formation.

2. Independent audits are a vital ingredient in the scheme of control over the conduct and accountability of the corporate entity within our society.

It is understandable, then, that when audited financial statements prove to have been misleading on the basis of subsequent events, such as unheralded business failures, questions are raised as to how this could happen. Assumptions are made that the auditors failed to meet their responsibilities either as a result of deficient performance of their work, or worse, that they knowingly placed their imprimatur on misleading financial statements.

These perceptions stem in large part from the often unconscious belief that an auditor's opinion should be expected to provide an absolute guarantee that:

1. The financial statements are reliable without qualification and that
2. Any material management frauds have been detected and disclosed.

Even more extreme is the expectation that the auditor is representing by his opinion that the judgments and actions of management have been of high quality and in the best interests

of all who may rely on the financial statements. Some also seem to expect that an auditor's opinion denotes that investment in or extensions of credit to the company will be both safe and profitable.

These exaggerated expectations contribute heavily to the belief on the part of many critics that the profession is failing to satisfactorily carry out its mission. Anything less than zero defects in financial reporting is viewed by these individuals as being unsatisfactory.

The profession devoutly shares the desire to reach such a state of perfection in an imperfect world. But attainment of such an objective is not a realistic expectation. Among the principal reasons why this is so are:

1. Cost/benefit considerations necessarily place limits on the amount of audit tests that are performed. Thus audit tests are applied on a sample basis rather than to 100% of all transactions.
2. Even if 100% of all transactions are verified the reliability of financial statements could not be absolutely guaranteed because they are based upon guesses about the future such as collectibility of receivables or the useful lives of productive facilities.
3. Management fraud defies detection by due auditing care when it involves cleverly executed collusion

between related parties, forgery or transactions which are not recorded on the books or records.

4. The auditing profession, like all professional groups, cannot reasonably expect to eliminate all breakdowns in performance or integrity on the part of a small percentage of its members.

Because these factors make it impossible for auditors to provide absolute assurance as to the reliability of financial statements the question is often asked "what good are audits if they don't provide complete protection?" The answer, of course, is that audits do provide a reasonable degree of protection and do prevent many cases where financial statements would otherwise be misleading. The fact that zero defects are not achieved is not a valid basis for concluding that the auditing function is necessarily being performed in an unsatisfactory manner.

Even though perfection is not attainable, the profession has a responsibility to strive constantly to improve the effectiveness of audits to the maximum extent that is reasonably achievable. Accordingly it is entirely appropriate to ask the question of whether the profession is satisfactorily meeting that responsibility.

To answer that question, the AICPA appointed a special commission in 1974 to examine the responsibilities of auditors in the light of legitimate expectations of the public. Prior to his

untimely death, the Commission was chaired by Manuel Cohen, former Chairman of the SEC. The Commission was initially composed of seven members, four drawn from other disciplines and interest groups and three from the ranks of the auditing profession.

A report on its preliminary conclusions was published on April 1, 1977. Based upon responses and public hearings on its tentative views the Commission has now completed its work and its final report has just been published. The report contains over 40 recommendations for improving the way in which the profession meets its responsibilities. The conclusions are based in part upon an extensive body of research into the underlying causes of the allegations directed at the auditing profession. Unfortunately the Commission directed only a limited amount of its attention to the question of whether public expectations were unreasonable and, if so, what might be done to solve this problem.

In the meantime, while the Commission was deliberating, the fast-moving developments within federal government circles relating to the profession made it necessary for the profession to respond in its own behalf to the allegations being made about its performance. The Metcalf subcommittee staff study of the profession and the Moss subcommittee report on its oversight of the SEC raised a number of fundamental questions that required an immediate and comprehensive response if unwanted legislation was to be avoided.

In general, it was asserted in these reports that the performance of auditors is not as good as it should be. The

reasons for this judgment were not clearly articulated but invariably when this judgment is made the number of spectacular business failures which occurred during the last decade are cited as evidence.

To a large extent the criticisms are a result of a loss of confidence in the integrity of business. The energy crisis spawned widespread doubts about the reliability of the financial and statistical reports of the oil and gas industry. The revelations about illegal political contributions, bribes and off-book slush funds caused untold damage to the credibility of corporate management.

It does not follow, of course, that these events were necessarily accompanied by failures of auditors to meet their responsibilities. Nevertheless it is clear that the result has been a serious erosion in the credibility of the independent auditors. This loss of confidence is focused principally on perceptions that audit failures occur because:

1. The accounting and auditing standards being set in the private sector are deficient in quality, quantity and timeliness. Therefore it is suggested by some that the setting of these standards should be transferred to a government agency.
2. The auditors were negligent and exercised poor judgment or were not sufficiently independent of their clients and either knowingly or

unconsciously protected the interests of management at the expense of shareholders and other users of financial statements.

3. The profession's technical, independence and due care standards are not being enforced and CPAs and CPA firms are not being adequately punished. Therefore the SEC is urged by the critics to exercise its enforcement authority more vigorously and additional forms of governmental regulation of the profession are alleged to be necessary.

These perceptions are so serious that the profession can ill afford to ignore them even if they are greatly exaggerated. I believe it is safe to say that a great majority of the profession would vigorously assert that such conclusions are not supported by the facts. Unfortunately it is difficult to mount objective proof that the indictment of the profession's performance is either warranted or unwarranted.

In any event, if those who are judging the profession are convinced that reforms are necessary it is not terribly effective to tell them their judgments are faulty and to engage in what has become popularly known as "stonewalling". The distinctions between appearances and fact have become so blurred in our society that it is almost irrelevant as to whether appearances are distorted. Thus the profession has taken action

to effect changes based upon the allegations of its critics even though I am certain that a great many CPAs are unconvinced of the validity of the necessity for such reforms.

Because of the perceived deficiencies in the performance of auditors and the accountability of corporate management there has been an avalanche of recommendations for reform. These have been put forward by congressional committees and their staffs, the Commission on Auditors' Responsibilities, the SEC and by CPAs themselves in their testimony and written submissions to Congress. Some of the suggested changes were already under consideration by the AICPA even before they were recommended by others.

Many of the changes, particularly those in response to the Commission on Auditors' Responsibilities, are aimed at improved corporate accountability. Others are intended to bolster the independence of auditors and establishing an effective system of regulation of CPA firms.

For purposes of simplification I will discuss the more important recommendations under four categories:

1. Accounting and Auditing Standards.
2. Independence of Auditors and Improved Corporate Accountability.
3. Regulation of the Profession.
4. Relief for Small and/or Closely Held Businesses.
5. Other Matters.

Because of time constraints I will discuss only very briefly each of the items under these classifications. I believe this will be sufficient to convince you that the profession is indeed undergoing major and far-reaching changes and that many of the changes will have a significant impact on corporate accountability.

I. Accounting and Auditing Standards

At various times individual members of Congress have expressed concern about allowing the private sector to set accounting standards. Some have alleged that misleading financial statements have occurred because the private-sector standard setting bodies have been unwilling to eliminate accounting alternatives that were advantageous to corporate interests. These critics tend to assert that the auditing profession has been the captive of its clients and is not to be entrusted with direct responsibility for setting the standards.

The suggested cure has been to transfer the standard-setting to a government body. Some have urged that the SEC exercise its existing statutory authority by rescinding its policy of looking to the FASB. Others have recommended that the GAO or a wholly new governmental body be given the responsibility to set accounting standards.

As a result of a vigorous defense of the FASB before congressional committees it currently appears that the recommendations for government setting of accounting standards will not prevail.

This issue has, at least for the time being, cooled down and been replaced by proposals for additional federal regulation of the profession. Nevertheless the present arrangement between the SEC and the FASB is not entirely secure and its future is inextricably intertwined with the fate of the profession with respect to possible federal regulation.

The jurisdiction over the setting of auditing standards has also become the subject of recommendations for change. Congressman Moss has suggested that such standards be set either by the SEC or under a statutory regulatory body for the profession similar to the National Association of Securities Dealers. Also the Commission on Auditors' Responsibilities has recommended that the Institute's present auditing standards executive committee be converted into a full-time paid board and suggested other structural changes, as well.

In response to these recommendations the Institute appointed a special committee to study the present structure of AudSEC and recommend what changes, if any, should be considered in the way auditing standards are established. The committee is in the final stages of its study and is expected to report its conclusions to the AICPA's Board of Directors this spring.

Retention of the establishment of both accounting and auditing standards in the private sector is dependent to a large extent upon whether the profession is successful in avoiding legislation to establish an NASD type regulatory system for the

profession. If such a statutory regulatory body were to be established under the oversight of the SEC the odds would be very high that the functions of both AudSEC and the FASB would be included under the new regulatory structure. It is important, therefore, for members of industry to recognize that they have a stake in the fate of the profession with respect to federal regulation.

II. Independence of Auditors and Improved Corporate Accountability

The concerns of the SEC and Congressional committees regarding the independence of auditors are based upon the more fundamental desires to achieve improvements in corporate accountability. Therefore any steps to enhance the independence of auditors are really directed toward both objectives and I shall discuss them in this content.

Perhaps the most important of the many recommendations under this subject is the belief that independent audit committees will be the cure for a great number of perceived deficiencies. The role of such committees is to act as a watchdog over the conduct of management and to serve as a buffer between management and the independent auditors.

The AICPA's Board of Directors, at the strong urging of the SEC, has appointed a special committee to study whether and how the AICPA could impose a requirement for a public company to have an audit committee as a condition of expressing an unqualified audit opinion on the company's financial statements. The Institute has agreed to use its best efforts to achieve such an objective

probably through the establishment of an auditing standard requiring a disclosure if a company fails to have a prescribed type of audit committee.

In addition to audit committees a number of other measures have been suggested by the SEC, the Commission on Auditors' Responsibilities and the report of the late Senator Metcalf's subcommittee. The Institute has acted in response to each of these recommendations and I will mention each of them very briefly.

1. The AICPA Board of Directors has endorsed the concept that auditors review and publicly report on systems of internal control of SEC companies as separate engagements but not as a condition to expressing audit opinions on financial statements. It has directed AudSEC to develop standards for such engagements. A special advisory committee composed principally of industry representatives is working on the development of criteria for evaluating systems of internal control. In the meantime AudSEC has issued a standard requiring auditors to report on internal control deficiencies to boards of directors or audit committees.
2. The AICPA Board has endorsed the recommendation that a report by management be included with financial statements indicating the responsibilities

being assumed by management. A special committee including industry representatives has been appointed to develop the suggested form and content of such a report.

3. The AICPA Board has endorsed the concept of adoption by management of policy statements on expected conduct and that auditors should, as a separate engagement, review and report on management's actions to assure compliance with its policy statement. AudSEC has been directed to develop standards for such reviews and reports and a special committee has been appointed to develop a model for policy statements on conduct.
4. The AICPA Board has endorsed the recommendation that auditors be engaged, dismissed and make their fees arrangements with the audit committee or board of directors of their publicly-held audit clients. Implementation of this arrangement will be studied by the special committee on audit committees.
5. The AICPA Board has embraced the concept that auditors should be required to attend the annual shareholder's meetings of their publicly-held

audit clients. The special committee on audit committees will also seek ways to implement this requirement.

6. The AICPA Board supports the recommendation that the present information required in 8-K reports, when there is a change in auditors, should be disclosed in all audited financial statements of SEC companies. However it is opposed to the inclusion of reasons for the change as currently being proposed by the SEC. The special committee on management reports will seek ways to implement disclosure in financial statements of the 8-K information.
7. The SEC Practice Section for CPA firms has established a requirement for its members that all disagreements with SEC audit clients which, if not resolved, would have resulted in a qualified opinion, be reported in writing to the client's audit committee or board of directors.
8. The SEC Practice Section for CPA Firms has, among others, adopted the following requirements for its members:
 - a. Proscribed the performance of consulting engagements involving psychological testing,

public opinion polls, mergers and acquisitions for a fee and certain aspects of marketing and plant layout. Actuarial services and executive recruiting are currently being studied to determine the extent to which such services should be proscribed.

- b. Annual reports to the audit committee or board of directors of SEC clients on the amount of consulting fees and descriptions of the types of consulting services provided during the year.
- c. Annual reports to the section, for inclusion in files open to the public, the per cent of total fees represented by each of consulting, tax and accounting and auditing services.
- d. Annual reports of the names of all SEC clients from which the fees exceed 5% of the member's total fees.
- e. Mandatory rotation every five years of the audit partner in charge of the audits of all SEC clients.
- f. Mandatory concurring reviews of audit reports

of all SEC clients before issuance of such reports. A concurring review is one which is conducted by a person not otherwise involved in the audit.

There is little doubt that as all of the foregoing measures are implemented there will be improvement in both the independence of auditors and in corporate accountability. However, I fear that people in government may have expectations that these actions will be a great panacea for past deficiencies and that no future difficulties will be encountered in financial reporting or corporate conduct. If this is the case we are destined to experience another round of investigation, hearings and criticism at some future date. Let us hope that the perceptions at that time will be more realistic and less cynical and the expectations more reasonable.

III. Regulation of the Profession

Congressman Moss's subcommittee recently completed hearings which focused on the progress of the profession toward establishing an improved system of self-regulation. Mr. Moss has stated publicly on several occasions that if he was not satisfied he would introduce legislation to establish a quasi-governmental body similar to the NASD and under the oversight of the SEC to regulate the profession.

The Institute's response has been to establish a division for CPA firms with two sections, one for SEC Practice and another for Private Companies Practice. The two sections are substantially

parallel except that some of the requirements of the Private Companies Practice Section are tailored to be more relevant to needs of non-public companies.

The SEC Practice Section imposes regulatory requirements on participating firms (in addition to those previously mentioned) as follows:

- a. Mandatory continuing professional education of 40 hours a year for all professional staff members.
- b. A mandatory peer review of the firm at least every three years and at such other times as may be imposed as part of a disciplinary action. Such reviews will include investigation of whether unreasonable time or fee pressures are adversely affecting the quality of audits.
- c. Imposition of sanctions on firms found to be deficient in meeting the quality control standards of the AICPA.
- d. Annual filing of relevant information about the firm for inclusion in files open to public inspection. This will not, however, include financial statements.
- e. Maintenance of minimum amounts of legal liability insurance as prescribed by the executive committee of the section.

The key to the success of this self-regulatory scheme for CPA firms with SEC practice is the appointment of a Public Oversight Board to monitor the operations of the section and report at its discretion any information, findings or views to the SEC, congressional committees or the public at large. The Board will:

- a. Consist of five prominent individuals from outside the profession and having unquestioned reputations and integrity.
- b. Have access to all files, meetings and activities of the section.
- c. Have authority to hire its own staff as required.
- d. Be compensated from dues charged to member firms.

Although membership in the section is voluntary it is believed that peer, client and public pressures will cause membership for firms auditing SEC companies to be mandatory for all practical purposes.

It is too early to know whether the Institute's program for self-regulation will function satisfactorily or whether it will be given a chance to prove itself. Congressman Moss may introduce his proposed legislation despite a hearing record that does not support such action at this time. Also, the Institute has been sued by a group of members seeking to force submitting the division for firms program to a membership referendum.

Even though the outcome of these challenges is uncertain I am optimistic that legislation will not be enacted at this time and that the courts will confirm that a membership referendum is not required under the Institute's bylaws. Given the opportunity to function I believe that the division for firms will prove to be an excellent vehicle for effective self-regulation.

IV. Relief for Small and/or Closely Held Businesses

There is growing awareness within the profession and in other sectors as well that in setting accounting standards too little attention has been paid to their relevance when applied to smaller privately held companies. It has become increasingly obvious that standards designed for publicly-held companies do not always make sense with respect to non-public companies. Some types of disclosures are either irrelevant or their costs far exceed any benefits to the users of financial statements in the particular circumstances.

The report of the late Senator Metcalf's subcommittee and the report of the Commission on Auditors' Responsibilities both recognized this problem and urged that it be given greater attention.

The Institute has been addressing this problem with increasing urgency over the past three years. It has taken several steps:

1. A special committee has been working with the FASB, the SEC and the AICPA Board of Directors to urge the FASB to limit application of certain portions of the financial accounting standards to publicly-traded companies. The committee has issued a report containing its recommendations and the Board of Directors is awaiting the outcome of current deliberations on this matter by the FASB. Preliminary decisions on how to deal with the problem are expected to be reached this spring.
2. A previously appointed subcommittee of AudSEC to deal with the subject of unaudited financial statements has been upgraded to the status of a senior committee with the authority to issue its own standards on accounting and review type engagements. An exposure draft of its first proposed pronouncement has just been issued.
3. The Private Companies Practice Section has been established in part to facilitate tailoring practice standards to recognize the differences in needs of smaller privately-held companies. By institutionalizing the differences the need for their recognition when setting standards will be more widely accepted.

Providing for exceptions in the application of standards poses a difficult problem of educating users of financial statements. In addition, many practitioners have an uneasy feeling that differential standards based upon size and ownership of companies will lead to public perceptions that there are first and second classes of financial statements and first and second class auditors. Of course, this condition already exists to the extent that there are unaudited and audited classifications.

The public and the profession cannot have it both ways. Relief from unduly burdensome standards cannot be achieved for smaller privately-held businesses without adopting exceptions in the application of the standards required for publicly-traded companies. I believe the time is overdue to start making such exceptions and that we will embark upon this course in the coming months.

V. Other Matters

The Institute has a great number of other changes underway which are in various stages of implementation. I will simply list them for you without further explanation.

1. Meetings of Council and senior committees are now open to the public.
2. We are balloting on adding three public members to the Board of Directors.

3. We have reduced big 8 representation on all senior committees to five or less.
4. We have removed some of the secrecy from disciplinary actions.
5. We are balloting on modification of the rules on advertising and solicitation, incompatible occupations and employment of employees of other CPA firms.
6. We are embarked on a program to overhaul the present standard auditor's report.
7. Adoption of a separate footnote describing uncertainties is being urged for adoption by the FASB.
8. A continuing committee on searching for and detecting fraud has been appointed.
9. We are attempting to develop criteria for departures from generally accepted accounting principles when there are unusual circumstances.

Summary and Conclusion

I believe that you will agree that what I have just described constitutes an impressive and massive response to

nearly all of the criticisms and recommendations that have emanated from the two congressional subcommittees and the Commission on Auditors' Responsibilities. To be sure, many of the actions will require a good deal of time to be fully implemented. But the important thing is that they are all in motion and have the full support of the Institute's governing bodies. Parts of the program will require the cooperation and action by management or other entities. However we are dedicated to using our best efforts to achieve the objectives that have been adopted.

We hope that the result of all these efforts will be:

1. Retention by the private sector of the authority to establish accounting and auditing standards.
2. Enhancement of the credibility and accountability of corporations and management.
3. Enhancement of the quality of work and the independence of auditors and the credibility of the profession.
4. Better regulation not only of individual CPAs but of CPA firms under a self-regulatory scheme and avoidance of the imposition by legislation of a federal regulatory body for the profession.
5. Greater participation by local practitioners in the affairs of the profession.

6. Establishment of a basis for drawing distinctions between public and smaller non-public companies for purposes of applicability of technical standards.

Will we be successful in achieving these results? No one can say for certain, but I sincerely hope so. If we fail, it will not be because we did not try our best to correct our faults as perceived by our critics. Frankly, I know of little else that we might do except to find a way to become godlike infallible creatures with powers to perform miracles.

Despite all the problems I remain highly optimistic. If we have the will, the imagination and the statesmanship we can all make a great contribution to preserving our free enterprise system and arresting the trend toward an all pervasive federal government.