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by

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by Wallace E. Olson, President, AICPA

Any useful discussion of the auditing profession's effectiveness and credibility should start with an overview of why the profession has come under such heavy attack in recent times. The answer lies in the perceptions of the critics and the emerging recognition, particularly within Congress, of the importance of the role of auditors and financial reporting.

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:

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.

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 will be published at the end of this month. 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 such judgments are made the number of spectacular business failures which occurred during the last decade are cited as evidence. It does not, of course, follow that because there were such business failures they 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 profession. 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 that transfer of the setting of these standards to a government agency should be considered.

2. The auditors were not sufficiently independent of their clients and either knowingly or unconsciously protected their clients' interests at the expense of third party users of financial statements.

3. The auditors were negligent and exercised poor judgment in conducting their audits.

4. 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 should exercise its enforcement authority more vigorously and additional forms of governmental regulation of the profession should be considered.

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.

Having briefly covered the background of the problem of credibility facing the profession I will devote the balance of my remarks to describing the many actions that are being taken to bolster the confidence of the critics. These actions are based largely upon a composite of recommendations that emerged from the Metcalf report and the report of the Commission on Auditors' Responsibilities. Many of the recommendations were put forward by CPAs themselves in their testimony and written submissions to Congress. Some of the actions were already under consideration by the AICPA well before the recent avalanche of criticism and recommendations.

Many of the actions, particularly those in response to the Commission on Auditors' Responsibilities, will have a significant impact on the corporations being audited and are aimed at corporate governance. Others are directed toward bolstering the independence of auditors and establishing an effective system of self-regulation of CPA firms.

For purposes of simplification I have classified the actions under six categories:

1. Auditing standards and peformance.
2. Independence of auditors.
3. Regulation of CPA firms.
4. Discipline of individual CPAs.
5. Management of the AICPA.
6. Other matters.

Because of time constraints I will give only a brief explanation of 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.

I. <u>Auditing Standards and Performance</u>

1. A special committee has been appointed to study the present structure of the AICPA's Auditing Standards Committee to recommend what changes

if any should be considered in the way auditing standards are established. A report is expected in the spring of 1978.

2. Modification of the present standard auditor's report is under intensive study. Under consideration are:
    a. A proposed standard which would eliminate the use of "subject to" qualifications based upon uncertainties and contingencies.
    b. The elimination of references to "fairly" and "consistency".
    c. A directive by the AICPA Board of Directors to AudSEC to develop a revised report that will be a more effective communication device.

3. 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.

4. The AICPA Board has endorsed the concept that financial statements should contain a separate footnote devoted to describing uncertainties. It has directed the Accounting Standards Committee to study the matter and make recommendations to the FASB for implementing such a requirement. Also a special committee including FEI and ABA representatives is being appointed to develop examples of such footnotes and to define the role of lawyers with respect to disclosures on legal liability uncertainties.

5. 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.

6. 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.

7. AudSEC has issued a standard defining more clearly the duties and responsibilities of auditors in searching for and detecting fraud. Also a standing committee has been appointed to monitor and publish (for the guidance of auditors) analyses of the types of frauds and audit failures that are encountered in practice.

8. The AICPA Board concluded that in setting accounting standards the responsible body already takes into account preferability among alternatives and where alternatives are not eliminated there is the presumption that the standards setting body found no sound basis for preference. However, in rare cases, it is preferable, due to unusual circumstances, to depart from GAAP to make financial statements not misleading as provided by AICPA Rule of Conduct 203. The Board directed AcSEC to attempt to develop criteria to determine when departure from GAAP is required, due to unusual circumstances, to make financial statements not misleading.

9. The AICPA Board has concluded that more attention should be paid to the relevance of applying to smaller or privately-owned companies, all the same standards applied to public companies. Also the AICPA Council established a new senior technical committee to set standards for accounting and review service engagements involving unaudited financial statements. An exposure draft on standards for unaudited financial statements is expected to be released at the end of this month.

II. Independence of Auditors

1. The AICPA 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 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.

2. The AICPA Board has endorsed the recommendation that auditors be engaged, dismissed and make their fee 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.

3. 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.

4. The AICPA Board supports the recommendation that the present information required in 8-K reports, when there is a change of 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.

5. 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.

6. 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 if any 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.

III. Regulation of CPA Firms

1. An SEC Practice Section for membership by CPA firms has been established within the AICPA which imposes regulatory requirements on the member 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 effecting 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.

2. 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.

3. 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.

IV. <u>Discipline of Individual CPAs</u>

1. The AICPA Council has approved a requirement to publish the names of all individual members found guilty of charges as a result of a trial board

proceeding. Prior to such action the trial board could elect to not publish names and has often availed itself of this election.

2. The AICPA Board has directed the publication of periodic reports giving statistics on and the status of all disciplinary actions.

3. A special committee is studying other steps that might be taken to open disciplinary proceedings to the public.

V. <u>Management of the Institute</u>

1. All portions of meetings of nine AICPA senior committees and the governing Council, when policies and technical standards are being discussed, will be opened to the public commencing January 1, 1978.

2. A proposal to amend the AICPA bylaws to permit the addition of three public representatives as members of the Board of Directors and Council is being submitted to the members for approval.

3. Representation of Big 8 firms on all senior committees of the AICPA has been reduced to five or less on each committee.

4. The AICPA Board of Directors has concurred with the removal of its powers of appointment of the trustees of the Financial Accounting Foundation.

VI. Other Matters

Modification of the Institute's rule of conduct prohibiting advertising and solicitation to remove virtually all restraints except deception and false statements has been proposed to the members. Also modification of the rule prohibiting incompatible occupations and repeal of a rule prohibiting the initiation of employment of employees of other CPA firms are being proposed. These changes in the AICPA's code of ethics will be voted on by the members during the first two months of 1978.

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 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 profession of the authority to establish auditing standards.

2. Enhancement of the quality of work and the independence of auditors.

3. Better regulation not only of individual CPAs but of CPA firms under a self-regulatory scheme.

4. Greater participation by local practitioners in the affairs of the profession.

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

6. Enhancement of the credibility and effectiveness of the profession.

7. Avoidance of the imposition by legislation of a federal regulatory body for the profession.

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 slings and arrows I remain highly optimistic. Ours is a growth profession. We have only scratched the surface of the full potential of our role. If we have the will, the imagination and the statesmanship we will continue to earn a position of high esteem for our contribution to our free-enterprise society.

As Senator Metcalf said, "the ball is in your court".