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Dispelling a Myth

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The courts commonly distinguish between licensing statutes that are regulatory in character and those which are enacted merely to raise revenue. A regulatory statute is one designed for the protection of the public against unqualified persons. The object of such a statute, then, is to promote the public welfare by permitting only persons with the necessary qualifications to receive the license.

Over the years, a principle of law has been fairly well established that groups licensed for regulatory purposes have been allowed to establish their own rules of conduct and standards of performance that must be followed in the conduct of the work for which the license was granted. While Certified Public Accountants perform many varied types of service to the public, the only service for which the CPA is uniquely licensed is the performance of an audit.

The profession, in section 110.01 of the Statements on Auditing Standards, defined the purpose of an audit as:

> *The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position in conformity with generally accepted accounting principles. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion.*

Since Certified Public Accountants are licensed through the auspices of regulatory statutes and exist for the purpose of promoting the *public* welfare, it seems appropriate to inquire into the perceptions of an auditor's duty as seen by that public. This paper addresses the question of what the public expects from auditors.

Many different groups have attempted to speak for the "public" as the following paragraphs will suggest.

The opinion handed down in the 1136 Tenants Corporation case had four points that were made in the decision that are very important to practicing CPAs (the decision was upheld by the New York Supreme Court):

1. A write-up engagement requires certain definitive audit procedures.
2. Hiring a CPA presumes an audit.
3. An audit may be adequately performed without independent verification.
4. Accountants have a duty to detect defalcation.

All four of these points in the decision were very disquieting to the profession. The first three points can be, and are, being adequately dealt with by authoritative pronouncements which insure that, when adhered to, the CPA can effectively limit possible liability through "sound practices." Points one and two, for instance, can be dealt with by having an adequately constructed engagement letter. The Parol Evidence Rule will not allow oral testimony to contradict what is present in a written contract. Thus, if the engagement letter says clearly that no audit is intended, it would be difficult if not impossible for the client to say that an audit was contemplated. Point three also could be dealt with through the engagement letter and the new categories of service — Compilation and Review — should clearly delineate the fact that CPAs can and do provide different levels of service that are in the general area of the attest function. Point four, however, presents more of a problem since it addresses a duty of a professional that is licensed to promote the public welfare.

In the Equity Funding case, nineteen or more members of top corporate management perpetrated a massive fraud. The fraudulent activities were: 1) creation and inflation of assets, 2) borrowing cash without recording a liability, and 3) creation of phony insurance policies. The auditors failed to detect the fraud. The failure to adhere to generally accepted auditing standards was held to be gross negligence on the part of the auditors. Fraud, as defined by the courts, must usually include a willful intent to defraud; but in Equity Funding the courts held that the gross negligence of the auditors was equivalent to fraud. Thus, the auditors were found guilty of being a party to the issuance of false financial statements and were sentenced to jail terms.

In both the Equity Funding and 1136 Tenants' Corporation cases, the courts found that the auditors *should have* detected the frauds;

however, the Supreme Court reached an opposite conclusion in Hochfelder. The fraud was perpetrated by the president of the First Securities Company of Chicago. The president diverted funds for his own use which customers of the company had given him. The checks were made out and addressed to the president. The president had a "mail rule" which said that all mail addressed to him was to be opened only by him. The auditors did not investigate the "mail rule" and they did not discover the fraud. The fraud was disclosed by the president in a suicide note. The defrauded customers sued the auditors for negligence under Rule 10b-5. The court, however, found the auditors were not guilty under the 10b-5 reasoning that mere negligence does not constitute fraud on the part of the auditor. Mere negligence is the failure to exercise ordinary care in the performance of a duty, while gross negligence is the failure to exercise even slight care.

The Supreme Court, in their ruling on the Hochfelder case, did not attempt to define public policy by defining or limiting the liability to the public accountant for failing to detect fraud. In a footnote to the opinion, the court did cite the Ultramares decision but did not use Ultramares to further explain its reasoning. In Ultramares, Cardozo gave this opinion on the auditor's liability for negligence:[1]

> *If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.*

These court cases indicate that the judiciary is not yet ready to clearly define how much responsibility the auditor should have for the decision of fraud. The Hochfelder decision simply stated that mere negligence on the part of the auditor is not fraud. The court did not state whether compliance by auditors with the standards of the profession is sufficient to prevent the auditor from becoming liable for failing to detect fraud.

The informed investor is apparently not satisfied with the position the profession has taken on the detection of fraud. A 1975 survey[2] (taken before SAS 16 was issued) surveyed corporate financial managers, bankers, and financial analysts. Those surveyed felt that auditors had a substantially higher responsibility to detect material fraud than auditors felt they had. While auditors felt that their responsibility for fraud detection should be lessened, the informed investors felt that the responsibility for the detection of fraud should be increased. In another survey, two-thirds of the shareholders surveyed felt that the certified public accountant's most important function was to detect significant fraud. This survey was also taken before SAS 16 was issued.[3] Since these surveys were taken before the issuance of SAS 16, they may not reflect the feelings of informed investors currently.

In 1974 the American Institute of Certified Public Accountants established a Commission of Auditor's Responsibilities, commonly known as the Cohen Commission. The formation of the Cohen Commission was an attempt on the part of the Institute to respond to criticism about the auditing profession. The final report of the Commission was issued in 1978. The Cohen Commission concluded that significant percentages of financial statement users consider fraud detection one of the most important objectives of an audit. The Commission said that although in its early years the accounting profession had recognized the importance of detecting fraud, this recognition had declined in recent years. The Cohen Commission concluded that the audit should provide reasonable assurance that the financial statements were not affected by material fraud. The auditor has a duty search for fraud and is expected to detect fraud by the exercise of professional skill and care.

In an apparent response to perceived public pressure, the following pronouncement was made a part of the Statements on Auditing Standards in 1978:

> *Under generally accepted auditing standards, the independent auditor has the responsibility, within the inherent limitations of the auditing process, to plan his examination to search for errors or irregularities that would have a material effect on the financial statements and to exercise due skill and care in the conduct of that examination.*

The high percentage of investors who never read the auditor's opinion is disquieting.

The Senate Subcommittee on Reports, Accounting and Management, otherwise known as the Metcalf Committee, generally endorses the recommendations of the Cohen Commission. Specifically, the Metcalf Committee said:[4]

> *The Cohen Commission recommended several reforms in the way auditors for publicly owned corporations perform their responsibilities. The recommendations were based on a reaffirmation of the auditor's function, which the commission said is to protect the public's interest against "biases, errors, and misrepresentations, including material frauds and illegal or questionable acts."*

In a similar but perhaps stronger statement, the Securities and Exchange Commission (SEC) has expressed the opinion that auditors should take more responsibility for detecting fraud. In 1974, John C. Burton said:

> *"Nineteen seventy-four might be called the year of the auditor. The historical position of the auditor, which seems to be that fraud is not what the CPA is responsible for finding has to be reconsidered. We have seen too many cases of management fraud where management has obscured the reality of the corporate activity from the auditor."*[5]

Former SEC Chairman Harold Williams, demonstrated agreement with Burton when he said about the Cohen Commission:

"I believe the Commission is saying that we can't expect the auditors to discover every management effort to defraud, deceive or conceal, but that the obligation to search is greater than accountants have historically admitted and that the obligation to disclose findings is greater than auditors have anticipated."[6]

The SEC thus believes that the purpose of the independent auditor is not only to give an opinion on the fairness of presentation of financial statements but also to make an effort to detect fraud. The SEC evidently believes that fraud detection is an objective which the profession should espouse in order to serve the public interest.

The courts, the AICPA, the SEC, and other advisory type groups are imputing or recommending responsibilities on the auditor for detecting fraud based upon their perception of what the public expects an audit to be. Since the expectations of the public are such a driving force, an effort was made to determine, at least in one locale, what these expectations are.

The technique which was used was somewhat unique for a survey of this type. Rather than a mail questionnaire, a telephone survey was undertaken. A significant cloud of doubt is frequently cast over mail surveys by persons who speculate about the motives of those polled who return the questionnaires. Typically, mail surveys have a low response rate which requires a large sample in order to obtain sufficient usable replies. In the present survey, a 100 percent response rate was achieved because of using the telephone; therefore the question of the respondent's motivation should not arise.

The Survey

The objective of the survey was to determine what four different groups of people surveyed perceived to be the primary purpose of the independent auditor. The groups chosen were: financial analysts, accountants who were not CPAs, managers and the general public. The population was the metropolitan Denver area. This area was chosen because about half the population of the state of Colorado resides in Denver. It was felt that the views of the people of the Denver area would probably reflect the views of Coloradoans as a whole, though not necessarily the views of the people of the United States. The results of the 1970 census were used to determine the size of the population and of the groups within the population. While the population of Denver has increased in size since 1970, the census figures were the best available and were therefore used to compute the sample size. A statistician was consulted to assure that the survey would be as unbiased as possible and to help establish the sample size and evaluate the results of the survey.

Telephone calls were made until the predetermined number of people within each group had been surveyed. Some bias may exist in the survey in that not all the residents of Denver have telephones. The effect of this type of bias on the survey is probably minor. The response rate on the survey was 100 percent since calls were continued until the predetermined sample size was reached.

The questionnaire was designed to be brief and unbiased. Brevity was necessary because people contacted by telephone often do not wish to respond to a long survey. The questions were designed to give some background of those surveyed as well as to determine the amount of exposure they had to auditing. The primary objective of the survey was to determine what the four groups surveyed perceive to be the primary purpose of the independent auditor.

The results of the survey were evaluated by using the Statistical Package for Social Sciences computer program. Cross tabulations were performed on the data, as well as the Chi Square test. Those results which had a level of significance of less than .10 were considered statistically significant and therefore acceptable.

The Questionnaire

1. Which of the following most clearly defines your occupation?
   a. financial analyst
   b. manager
   c. non-CPA accountant
   d. non-accountant
2. Which of the following most clearly reflects your level of education?
   a. less than high school
   b. high school
   c. some college
   d. undergraduate degree
   e. graduate degree
3. Do you own stocks in any companies which are audited by independent auditors?
4. If the answer to 3 was yes, do you generally examine the information contained in the financial statements, including the auditor's opinion?
5. Have you ever worked for a company which was audited by an independent auditor?
6. In your understanding, which of the following most clearly describes the primary purpose of the independent auditor?
   a. to detect fraud or theft by employees and/or management
   b. to give an opinion on whether or not the financial statements as a whole are fairly presented
   c. to check to see if every transaction a business had during a year is recorded properly
   d. other — explain
7. Of the four statements in the previous question, which do you feel should be the primary purpose of the independent auditor?

In Table I, the results of the survey are broken down by perception of the independent auditor's primary purpose and occupation of those who responded.

The first thing noted from the results of the survey is that a relatively small percentage of all the groups perceive the primary purpose of the independent auditor to be fraud detection. This is in sharp contrast to what is generally believed to be the perception of the public. Secondly, the table shows that those surveyed who have had more exposure to auditing because of the nature of their occupation have (as would be expected) a better idea of the auditor's primary purpose than those with little exposure. Thirdly, for the general public, a high percentage of respondents perceive the independent auditor's primary purpose to be check all transactions. The second highest percentage category were those who perceive the purpose of an audit to be the fair presentation of financial statements. These percentages indicate that, though a significant percentage of the general public understand what an auditor does, there is still an obvious lack of communication of the objective of an audit to the general public.

In order for the accounting profession to serve the public interest, it is necessary that the accountant's end product, the financial statement, be useful to the public. Some interesting statistics were obtained in this survey about stockholders and the audited financial statements which some companies issue (see questions 3 & 4 of the questionnaire). Of the persons surveyed, 35.3 percent owned stock in companies which issue audited financial statements. Of these stockholders only 36.6 percent often read the financial statements, including the auditor's opinion. Those stockholders who sometimes read the financial statements and the auditor's opinion were 14.6 percent of those stockholders surveyed. The stockholders who did not read the financial statements constituted 48.8 percent of those surveyed. This high percentage of people who seldom or never read the financial statements and the auditor's opinion is disquieting.

The survey also questioned respondents about their perception of what *should be* the primary purpose of the independent auditor. These results are presented in Table II. The answers in the other column included "don't know" and "give advice" but were too varied to classify further.

Of those in the first and third groups listed, a majority felt that the auditor's primary purpose should be to give an opinion on the fairness of financial statement presentation. Those in the general public and nonstockholder groups expressed more fragmented views on what should be the primary purpose of an audit. For all groups, detecting fraud was rated lowest as the primary purpose of an audit.

The results of a cross-tabulation of the level of education of the person surveyed with their perception of the primary purpose of the independent auditor are presented in Table III. In the category titled "Other" the answers include "give advice," "don't know," and answers which did not fit into the other three categories. There seems to be a definite increase in the proportion of those who correctly perceive the auditor's primary purpose according to the increase in the level of education. However, there is not a clear decrease in the proportion of those who believe auditors detect fraud according to the increase in the level of education.

	Occupation			
Perception	Financial Analyst	Manager	Non CPA Accountant	General Public
	%	%	%	%
Detect fraud	0	7.7	14.2	17.9
Fairly presents	80.0	53.8	64.3	34.5
Check every transaction	0	23.1	14.3	40.5
Don't know	0	0	0	6.0
Give advice	0	7.7	0	1.2
Other	20.0	7.7	7.1	0

Table I

	Perception of What Should Be the Primary Purpose of the Independent Auditor			
Classification	Detect Fraud	Fairly Presents	Check All Transactions	Other
	%	%	%	%
Financial Analysts, Accountants & Mgrs.	6.3	56.3	21.9	15.6
General Public	14.3	26.2	39.3	20.2
Stockholders	7.3	53.7	29.3	9.8
Non-stockholders	14.7	24.0	39.3	24.0

Table II

	Perception				
	Detect Fraud	Fairly Presents	Verify All Transactions	Other	Total
Education	%	%	%	%	%
Less than high school	38.5	7.7	38.5	15.4	11.2
High school	9.4	31.3	50.0	9.4	27.6
Some college	20.7	41.4	31.0	6.9	25.0
Undergraduate degree	6.1	57.6	27.3	9.1	28.4
Graduate degree	22.2	77.8	—	—	7.8
Totals	15.5	42.2	33.6	8.6	100.0

Table III

Conclusions

The first conclusion which may be drawn is that more research on the perceptions and desires of the users of financial statements is needed. If financial statement users do not find the information contained in the financial statements understandable and useful, the auditing profession is failing to properly serve the public interest. If Congress and the SEC are overemphasizing the need for greater efforts to detect fraud, the desires of the financial statement users are being misinterpreted. The goal of the profession should be to satisfy the desires of financial statement users, not the desires of governmental bodies. The auditing profession should also be concerned that the financial statement users understand the objective of an audit. An understanding of the information contained in the financial statements must be accompanied by an understanding of the auditor's report. The possibilities discussed above indicate a need for more research in this area on a nationwide scale.

Secondly, this study focused on the perception of the *primary* purpose of an audit. Further work should be done to determine a rank ordering of various sub-purposes of an audit including the types of fraud that are of most importance to statement users.

Thirdly, the profession should attempt to enlighten the public about the objectives of the independent auditor and the meaning of the information contained in the financial statements. There are several possible solutions for this problem. One is an educational program conducted by the profession. Such a campaign could be conducted in the schools or in the media or both. Another possibility is to have all audited financial statements contain a statement like the following: "For assistance in interpreting these statements, take them to a qualified professional." A third possibility is to expressly state in the auditor's report that the opinion is based upon the results of testing and sampling. Solutions like those above could help to clarify the meaning of the information in the financial statements for the public.

Finally, the profession should establish well-defined standards on the auditor's responsibility for the detection of fraud. Auditors need a standard against which their performance can be measured to determine the degree of negligence, if any, which exists when the auditor fails to detect material fraud. If the profession does not set standards in this area, the courts will set standards for the profession on a case by case basis.Ω

NOTES

1J. Jay Hampson, "Accountants' Liability — the Significance of Hochfelder," *Journal of Accountancy* 142 (December 1976): 69-74.

2C. David Baron, Douglas A. Johnson, D. Gerald Searfoss and Charles H. Smith, "Uncovering Corporate Irregularities: Are We Closing the Expectation Gap?" *Journal of Accountancy* 144 (October 1977): 58-59.

3Harvey Kapnick, "Management Fraud and the Independent Auditor," *Journal of Commercial Bank Lending* 58 (December 1975): 20-30.

4Official Releases, "Improving the Accountability of Publicly Owned Corporations and Their Auditors — Report of the Subcommittee on Reports, Accounting and Management, of the Committee on Governmental Affairs, United States Senate," *Journal of Accountancy* 145 (January 1978): 93.

5John C. Burton, "The SEC and the World of Accounting," *Journal of Accountancy* 138 (July 1974): 59.

6News Feature, "The Profession's Future: New SEC Chairman Harold Williams Speaks Out," *Journal of Accountancy* 144 (September 1977): 44.

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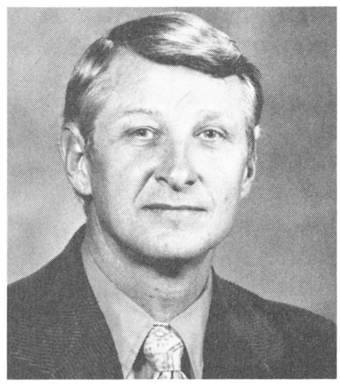

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