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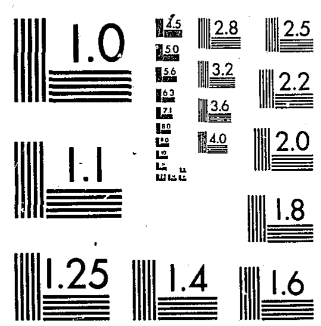

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ACCOUNTING AND AUDITING PRACTICES AND PROCEDURES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
REPORTS, ACCOUNTING AND MANAGEMENT

OF THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

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Memorandum of Comment by the American Institute of Certified Public Accountants on the Study by the Staff of the Subcommittee on Reports, Accounting and Management, U.S. Senate Committee on Governmental Affairs, Entitled "The Accounting Establishment"

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INTRODUCTION

The purpose of this memorandum is to respond to the recommendations presented in the study by the staff of the Subcommittee on Reports, Accounting and Management of the U.S. Senate Committee on Governmental Affairs, entitled "The Accounting Establishment." In so doing it will discuss the manner in which financial accounting and auditing standards are established in this country, the ways in which the independence of auditors is assured, and the forces, both public and private, that seek to assure the integrity of the financial reporting process. We believe this discussion will establish that there are presently in place in the accounting profession mechanisms, methods, and people that are fully capable of providing to the American people the assurances they want and need concerning the integrity of financial statements prepared by American business. Furthermore, this entire process is effectively overseen in the public interest by the Securities and Exchange Commission, which has been an active participant in the development of accounting standards since 1934.

This is not to deny the legitimacy of the concerns which motivated the staff study. In the wake of such dramatic business failures as *Penn Central* and such blatant management frauds as *Equity Funding, National Student Marketing,* and *Stirling Homex,* the demands for higher standards for all those concerned with the corporate process in this country—officers, directors, attorneys, auditors—have been insistent and proper.

While this memorandum has been approved by the Board of Directors of the Institute, it does not purport to reflect the views of all 130,000 members of the Institute.

No systems, in accounting or any other line of endeavor, can ever insure against human shortcomings; however, the risks of breakdowns in financial reporting are being steadily and speedily reduced. We hope that this memorandum will demonstrate the seriousness, the extensiveness, the vigor, and the success of the profession's efforts to improve financial reporting. And we believe that a federal initiative at this time would impede, if not destroy, these efforts and needlessly involve the federal government in the affairs of the profession.

Entirely apart from the merits of the charges made with respect to the past conduct of members of the accounting profession, a careful reading of the staff study shows no relationship between the charges against the profession, its bodies, and the SEC, and the business failures and misleading financial statements mentioned. Moreover, there is no evidence that the tight federal control of the profession proposed by the staff study would reduce hazards to the public.

Finally, this memorandum is not intended to present a point-by-point contradiction of incorrect information contained in the staff study or dispute each of the allegations contained in it; that will be done in the course of the upcoming hearings, submissions of other parties, and possible future memoranda from the Institute.

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

This memorandum is submitted by the American Institute of Certified Public Accountants (the Institute). The Institute is the national professional organization of certified public accountants. Certified public accountants (CPAs) are accountants who have completed extensive educational requirements and have passed a series of complex uniform examinations prepared by the Institute and administered by the accountancy boards in the various states. These accountants are licensed by the individual states and upon being so licensed may hold themselves out as "certified public accountants."

The Institute has about 130,000 members in all states of the Union. While there is no legal requirement that certified public accountants be members of the Institute, a very large majority of them are. The Institute conducts extensive educational programs to assist members in upgrading their skills and in keeping current with developments in the profession.

The ultimate policy-making body of the Institute is the Council, consisting of 255 members selected in part by state CPA societies and in part by election at large; other members serve by reason of their present or

past offices in the Institute. The Board of Directors, a body of 18 members, has the continuing responsibility for the conduct of the Institute's affairs.

SUMMARY OF THE STAFF STUDY AND QUESTIONS RAISED

The staff study, while it makes a multitude of allegations and a number of recommendations, nonetheless may be briefly summarized. It alleges that the entire financial accounting and reporting process in the United States is dominated by a group of 8 accounting firms (referred to as the "Big Eight"), aided by another 7 firms smaller in size than the "Big Eight." These 15 firms perform auditing services for a high proportion of the companies listed on the New York and American Stock Exchanges. The staff study charges that, while accountants associated with these firms account for only 11 or 12 percent of the nation's certified public accountants, they dominate the accounting profession and its principal organization, the Institute, by their membership on the Institute's governing and technical bodies. By domination of the Institute, it is alleged, they dominate the Financial Accounting Foundation, which is the "parent" body of the Financial Accounting Standards Board (FASB). The FASB establishes financial accounting principles in the United States. Thus, through this chain, it is asserted, the "Big Eight" dominate the establishment of accounting principles.

The staff study alleges that the Securities and Exchange Commission (the SEC) has abdicated its statutory obligations by permitting the accounting profession to establish accounting principles and has by various actions encouraged this activity in the private sector.

The staff study alleges that accountants are not independent of their clients, that they have failed to assure that the financial statements issued to the public are accurate and reliable, and that therefore various drastic measures should be taken to assure public accountability by the profession.

Basically, the staff study poses the following questions to which we will respond (parenthetical references are to the numbered recommendations set forth in pages 20 to 24 of the staff study). The Institute has not responded to those recommendations as to which others might more appropriately comment.

1. Are present financial accounting standards (sometimes called accounting principles) and the process by which they are established—private sector initiative accompanied by SEC oversight—adequate for protection of the public? (Recommendations 1, 2, 5, and 11.)

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2. Are present auditing standards and the process by which they are established adequate for protection of the public? (Recommendations 6, 7, 8, and 10.)

3. Are auditors sufficiently independent of their clients? (Recommendation 8.)

4. Are the Institute and the accounting profession dominated by the large accounting firms? (Recommendations 4 and 12.)

5. Are present standards for determining the liability of auditors to public investors fair and sufficiently protective of the public? (Recommendation 3.)

6. Is there excessive concentration in the supply of auditing and accounting services to large publicly owned corporations? (Recommendations 4 and 12.)

7. Is the disciplinary process that impacts the accounting profession sufficient? (Recommendations 8 and 14.)

8. Should the federal government refuse to engage for consulting work all firms that do auditing work for the government? (Recommendation 13.)

DISCUSSION

1. Are present financial accounting standards (sometimes called accounting principles) and the process by which they are established—private sector initiative accompanied by SEC oversight—adequate for protection of the public?
(Recommendations 1, 2, 5, and 11.)

The staff study charges that the process by which financial accounting standards are established is dominated by the "Big Eight" and that the failure of the profession and the SEC to insist upon elimination of alternative financial accounting standards has resulted in financial statements that are misleading to investors.

In the simplest terms, financial accounting standards are the rules governing how the information about business transactions is expressed and recorded in numbers, how the numbers are aggregated and arrayed, how they are reported, and how they are supplemented with textual disclosure to present the financial position of an enterprise at a particular moment in time, the results of its operations for a defined period, and the changes in its financial position during such period. Accounting is the process of applying financial accounting standards to the information about individual business transactions to produce financial statements which

aggregate the information about individual transactions in an orderly manner. Accountants, therefore, are those who have specialized proficiency in the accounting process.

The accounting process necessarily involves making innumerable judgments and estimates—the useful life of fixed assets such as a factory, and of intangible assets such as acquired goodwill, the collectibility of accounts receivables, the utility of inventories, and the appropriateness of tax accruals. This circumstance belies the common belief that financial statements are precise and exact, a notion that frequently results in criticisms of accountants when reasonable estimates prove in hindsight to have been off the mark.

The limitations of accounting and the accounting process were remarked upon recently by Professor George H. Sorter, chairman of the Department of Accounting, Graduate School of Business Administration, New York University:

> Misconceptions about accounting abound. Totally unrealistic expectations of accounting's role are held by many, including those that should know better. . . . Many expect accounting reports to "reveal" the value of a company, to establish the health or sickness of a company, to signal whether a stock is a good or bad investment. But that is not and cannot be the proper role of accounting. . . .
>
> Accounting provides complex information to be used in conjunction with other information. Decision makers then, based on their individual judgments, individual preferences and individual expectations, determine the value, health and prospects of a company project. . . .
>
> It is somewhat strange that a world that has reluctantly accepted a problematic weather forecast expects accounting reports to provide definitive forecasts of whether it will rain or shine on a particular company. . . .
>
> Not all significant economic activities can be communicated by accounting reports, and the user, in order not to be misled, must know which activities are included (*New York Times*, March 6, 1977, Sec. 3, p. 12).

Financial reporting standards are not "laws" or "givens" waiting to be discovered by a discerning eye, like the laws of physical science. Financial accounting standards are conventions—ways agreed on or determined by custom or authority—of measuring, combining, and stating information about business transactions. There is no such thing as an absolutely right or an absolutely wrong financial accounting standard. There will never be a system of financial accounting standards that is complete and immutable. There are continuing changes in the business practices that produce the information which in turn is organized and communicated by the application of financial accounting standards. For example, when franchising became a common business practice, franchisors applied then accepted accounting practices to increase income by immediately including franchise fees payable in the future. New financial accounting standards had to be developed to arrange the resulting information and communicate it in a manner that was not misleading—and standards were established by publication of an authoritative Institute guide. Until new standards were developed and promulgated, accountants relied on existing standards which had not been designed to deal with these innovations, since previously they had not been encountered frequently.

Before the 1930s, the efforts of the accounting profession to establish financial accounting standards received little support from other private or governmental groups. However, even before the 1929 crash, but with accelerating speed thereafter, members of the accounting profession were joined by the New York Stock Exchange and others in efforts to improve the integrity of published financial statements. The Securities Act of 1933 and the Securities Exchange Act of 1934 hastened and strengthened this process by giving to the newborn Securities and Exchange Commission broad powers to prescribe the content and forms of presentation of financial information in documents filed with it.

In 1938, after considerable study and internal debate, the SEC adopted Accounting Series Release No. 4. This stated that the Commission would accept in filings with it financial statements prepared in accordance with standards for which there was substantial authoritative support if the Commission had not expressed a contrary policy. In 1939 the Committee on Accounting Procedures was organized by the Institute for the explicit purpose of developing accounting principles.

By the mid-fifties, the absence of sufficient research and a theoretical framework was recognized as hampering the work of the Committee. The Accounting Principles Board (the APB) was launched by the Institute in 1959 with a mandate that placed heavy emphasis on research and the articulation of fundamentals. Largely as a result of pressures for the resolution of urgent practical day-to-day problems, compliance with the research portion of its mandate gradually diminished, as is described by the *Report of the Study on Establishment of Accounting Principles* issued in March 1972 (pp. 29–35). Out of this report came the Financial Accounting Standards Board. It is fair to say that with respect to every major criticism leveled at the APB a meaningful response was incorporated in the makeup and the procedures of the FASB.

This shift of responsibility for the establishment of accounting standards

represented a major, even revolutionary, shift. The Institute and practicing accountants no longer have final authority over the establishment of accounting standards. This authority now rests with the FASB, which was intended to be, and is, independent of the Institute. Under FASB procedures, the Institute is no different from any other group having opinions about financial accounting standards: It responds to FASB invitations to comment and is often disappointed, as are others, that its advice does not prevail.

Less than four years since its creation, the FASB is now being assailed by impatient critics. Its purported shortcomings, such as alleged slowness in coming to grips with important issues, are well publicized. Unfortunately, less well publicized have been its achievements. It has issued 20 drafts of proposed Statements, 14 Statements, 13 discussion memoranda, 18 Interpretations and has held 14 public hearings. This might be compared with the work of the Cost Accounting Standards Board (CASB), which was created in 1970 and on which the staff study has commented favorably: 18 drafts of proposed Standards, 14 Standards, 2 Interpretations, and one public hearing to evaluate Standards issued previously. This is not to suggest that the record of the CASB is to be criticized: The comparison simply points up the laudable accomplishments of the FASB.

Further indication of the profession's earnest efforts to develop financial accounting standards is the fact that the FASB's predecessors published 82 Opinions and Bulletins, as well as numerous Interpretations. These, together with the FASB's pronouncements, constitute the most extensive body of authoritative pronouncements on financial accounting standards in the world.

These achievements have by no means been easy. The FASB's second Statement, requiring the immediate write-off of research and development costs, although highly controversial, was, in the eyes of most, courageous. Statement No. 8, which requires immediate reflection of the impact of currency fluctuations on financial positions and operations, has drawn almost unanimous criticism from those most affected—American multinational enterprises. These and other examples amply demonstrate the independence of the FASB in its decision making. The active agenda of the Board is studded with controversial and difficult topics: A 360-page discussion memorandum on the conceptual framework for financial accounting and reporting has been published, and a 400-page discussion memorandum on accounting and reporting for extractive industries has also been published; public hearings have been scheduled on both of these problems.

The Institute is not aware of any evidence that any Statement or Interpretation has been influenced by the prior affiliations of Board members, by their membership in the Institute, by dependence of the FASB on the Financial Accounting Foundation for fund raising, by members' expectations of future employment in the profession, or by any other consideration antagonistic to sound financial reporting.

When the alleged shortcomings of the FASB are fully cataloged, there is no evidence that the job of determining financial accounting standards could better be done by a governmental body. Would the job be done more quickly? If so, it would be at the expense of the careful research, analysis, and opportunity for public hearings that have preceded FASB pronouncements. Would the determinations of a governmental standard-setting group be solely concerned with fair and full disclosure and protection of investors? Or would such determinations become infected with other considerations? Would a governmental body have decided to require a different approach to accounting for research and development to assist small business without concern for the effect of such a determination on investors in publicly held companies? (See p. 171 of the staff study, where this is intimated.)

The Financial Accounting Foundation, the parent organization of the FASB, has responded to the criticisms of the FASB. It has organized a committee to examine the structure and operations of the Board. This committee has interviewed extensively about 100 people who have had experience with the financial reporting process—accountants, businessmen, attorneys, government officials, educators, and many others—to secure a clear notion of the manner in which the work of the FASB is perceived and the ways in which it might be changed to better serve the public interest. This committee expects to report by the end of April.

As stated earlier, since 1934 the standard-setting process has been subject to the oversight of the SEC. An example of both the SEC's willingness to override pronouncements of the profession's standard-setting body when it thought such was appropriate and the hazards of expanding the control of the federal government over the establishment of financial accounting standards is seen in the lengthy controversy over accounting for the investment credit.

The investment credit is a credit against income taxes of a percentage of the purchase price of equipment purchased by a business. From its inception, controversy raged among businessmen and their accountants concerning the manner in which this tax credit should be handled: Some urged strongly that the effect on income should be spread over the life of the equipment purchased, while others urged equally strongly that the favorable effect on income should be reflected totally in the year of purchase.

In December 1962, following the enactment of the Revenue Act of 1962,

which included provision for the investment credit, the APB determined that the fairest presentation to investors would be spreading the effect of the credit over the life of the equipment. However, the SEC adopted a rule that either method could be used by those filing documents with the SEC, after which the APB retreated from its position and followed the SEC.

The controversy was rekindled in 1971 by the Revenue Act of 1971. This act again provided for an investment credit. This time Congress preempted both the SEC and the profession by decreeing legislatively that no one could require for the purpose of financial reports to any federal agency the use of any particular method of accounting for the investment credit. Thus, in the single instance in which Congress has decreed financial accounting standards, it opted for the use of any of a variety of standards (it did not even confine the options to the two most commonly used). Thus, Congress encouraged the very practice of "principle shopping" that the staff of the subcommittee has castigated the profession for failing to eliminate: It permitted issuers to select from alternative principles the one that would increase reported income.

The staff also makes much of the "flexibility" of accounting and implies that a vast range of alternatives is available to management each year. While some accounting alternatives exist, managements do not get to pick and choose from alternatives each year as if from a menu. In the unusual event of a change in accounting method, management must justify the change as being to a preferable method and must spell out the full effect in the financial statements and to the SEC.

There is no evidence in the staff study—unless speculation may be considered evidence—that the present process, now less than four years old, will not meet the needs of the users of financial information, will not expeditiously reduce the accounting options available to corporations, or will not promote the interests of investors better than any other system that might be conceived. Notably lacking in the staff study and its appendixes are complaints from users of financial information.

The staff study criticizes the profession for its adherence to the standard of "materiality"* (see p. 117 of the study) and charges that this results in misleading financial statements, particularly those of large companies. The concept of materiality is imbedded in the statutes governing

* Materiality has been defined by the SEC in several rules, all of which are similar to Rule 405 under the Securities Act of 1933:

> The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.

financial disclosure and the rules of the SEC under those statutes. The Securities Act of 1933 and the Securities Exchange Act of 1934 require the disclosure of *material* information and predicate liability of various persons, including the auditors, on a misstatement of or the omission to state, a *material* fact. Furthermore, the courts, including the Supreme Court, have made this concept the touchstone of their considerations of the adequacy of financial statements and other disclosures.

The auditor must be guided by the determinations of the courts and the SEC as to materiality. The concept is necessary to prevent financial statements from becoming overloaded with information of no use to those to whom the statements are primarily directed—the investors. By thus avoiding such excess, the financial statements are more useful. Even as constrained by this concept of materiality, financial statements of public companies are often criticized for containing too much information, perhaps thereby confusing investors.

If there were not such a concept as materiality to govern what should and should not be included in financial statements, neither management, nor auditors, nor courts would have any focus upon which to determine what should, and what need not, have been included in financial statements. Obviously, if an appropriate authority such as the SEC, the courts, or Congress determines that auditors should follow a standard different from that of materiality now imposed on them, they would make their judgments accordingly. But regardless of what label is put on it, any system of disclosure must include a criterion to determine what should be included in financial statements; otherwise every snippet of paper a corporation had would have to be published, resulting in nothing but confusion to investors. It should be noted that the FASB has done an extensive study of materiality, has published a discussion memorandum, and plans to issue a standard on the subject.

The staff study (p. 185) contrasts the cost of operating the Cost Accounting Standards Board with the cost of operating the FASB. This comparison, of course, ignores a number of distinctions. First, the CASB is concerned with establishing standards for one category of financial information, namely, costs, while the FASB addresses itself to all categories of such information—costs, revenues, assets, liabilities, and equity. Second, the CASB is only concerned with setting these limited standards for a limited group—certain government contractors; the FASB, on the other hand, establishes standards for all businesses—not just for those with government contracts, not even just for those publicly held. The complexity and scope of the FASB's task compared with that of the CASB are apparent. Finally, as seen earlier the output of the FASB in four years has far exceeded that of the CASB in seven.

In addition to the criticism of the FASB in the staff study, Senator Metcalf's transmittal letter states as one of his principal concerns the delegation by the SEC of its authority over accounting and auditing matters to "private groups."

The Commission has allowed the accounting profession, and the bodies the profession has organized, to take the initiative in establishing accounting standards. This was done after considerable debate within the Commission by the publication of Accounting Series Release No. 4, and was reconfirmed in 1973, when the Commission issued Accounting Series Release No. 150, by which it announced the policy of not recognizing principles which conflict with pronouncements of the FASB, except in the unusual circumstances—stated in Rule 203 of the Code of Professional Ethics of the Institute—where the use of another principle is necessary to prevent the statements from being misleading.

There is no evidence in the staff study, or elsewhere to our knowledge, that would justify the conclusion that had the Commission not adopted such a policy the quality of accounting and auditing would be different or better. Furthermore, this relationship between the Commission and the accounting profession has had the express or implied approval of chairmen and commissioners since 1938 with no discernible objection, of all chief accountants of the SEC since then, of virtually all preparers of financial information and of virtually all users of information. In short, the belief has been virtually universal that this relationship has been effective and protective of the public interest.

This practice has of course had the advantage of using the talents and experience of innumerable practitioners in the standard-setting process, at a cost incalculable but very substantial. If the entire activity of the FASB and its predecessors and the auditing standard-setting bodies had been carried out by a governmental body, the taxpayers would have borne a significant financial burden through the years.

However, this relationship has not by any means kept the SEC on the sidelines. Since its inception it has published over 200 accounting releases (78 of them since 1972); in late 1975 it commenced issuing staff interpretations based on experiences in processing filings with the Commission and inquiries from issuers and accountants, and thus far 14 have been published; it adopted Regulation S-X, which sets forth requirements with respect to the contents and format of financial statements filed with the Commission by various types of enterprises and which it has continuously amended to reflect changing needs. It is fair to say that the Commission has by rule making, by enforcement activity, and in other ways been quite aggressive in recent years in meeting its responsibility with respect to accounting matters.

Further, the Commission has maintained close liaison with the standard-setting bodies and has made known its views with respect to accounting principles and auditing practices. This liaison has clearly influenced the conduct of the private bodies.

The Commission and its staff have not been reluctant to take action when they believed the action taken by the private bodies inappropriate or unduly delayed. Thus in 1963 the Commission overrode the Accounting Principles Board with respect to accounting for the investment credit. Again in 1973, the Commission adopted disclosure requirements with respect to leases, notwithstanding the issuance of an Opinion on the subject by the Accounting Principles Board and the pendency of that matter on the agenda of the FASB. In 1975, the Commission became aware that in many cases income from early extinguishment of debt was unduly inflating the earnings of some issuers because existing APB Opinions required it to be reported as ordinary income. It urged the FASB to take action, suggesting that otherwise it would take action itself. The result was FASB Statement No. 4, which satisfied the concerns of the Commission. Similarly, when in an exposure draft the FASB appeared to favor price level accounting, the Commission took steps to require disclosure in footnotes to the financial statements of larger issuers of the replacement costs of inventories and fixed assets to reflect the effects of inflation.

An example of the manner in which the FASB and the SEC interface, and in which the SEC exercises its responsibility, is the release on December 2, 1976, of FASB Statement No. 13, pertaining to the accounting for leases. This provided for prospective application of its principles until 1981, when retroactive application will be required. The SEC is proposing that these principles, which it implicitly endorses, be applied immediately to practically all leases regardless of when they were entered into, thus requiring the application of Statement No. 13 sooner than intended by the FASB.

It is fair to say that the Commission and its staff have not been supine or indifferent to the manner in which private bodies have dealt with standard setting. To a greater extent than may appear from simply reading Accounting Series Releases Nos. 4 and 150, the Commission has actively overseen the development of accounting and auditing standards.

2. Are present auditing standards and the process by which they are established adequate for protection of the public?
(Recommendations 6, 7, 8, and 10.)

The staff study charges that the process of establishing auditing standards has been dominated by the "Big Eight" and that the standards have not been sufficiently rigorous.

A critical distinction should be noted between auditing and accounting. While intimately related, they are quite different. As mentioned earlier, accounting is the process by which financial accounting standards are applied to business transactions to produce financial statements. Auditing is the process by which someone other than the preparer determines whether the financial statements have been prepared in accordance with appropriate accounting standards.*

Obviously someone performing the audit function must have an intimate acquaintance with the financial accounting standards that were used in preparing the financial statements under review; otherwise, he would be unable to express an opinion that the statements were prepared in accordance with standards indicated as having been followed. Also, there is general agreement that for an auditor to perform his function effectively he must become familiar with the enterprise whose statements are being examined, particularly the system of internal accounting controls; the adequacy of this system will in large measure determine the nature and scope of the auditor's procedures.

The auditing process consists of two parts: (1) Performing the various procedures and tests necessary to form an opinion about whether the financial statements are properly presented, and (2) reporting on the financial statements as the result of that examination.

The standards by which independent auditors make their examination, the procedures they use, and the contents of their report have evolved over a period of time under the aegis of the committees of the Institute. Ten basic generally accepted auditing standards are contained in *Statement on Auditing Standards No. 1* (in view of the staff study's allegation that the "Big Eight" dominate the establishment of standards, it should be noted these most important basic standards were adopted by the membership of the Institute in the late forties). Interpretations of those standards are proposed and adopted by the Auditing Standards Executive Committee of the Institute as business and economic development require. For instance, in response to a perceived need, the Committee has recently issued two statements—one relating to the detection of errors or irregularities in financial statements and the other relating to illegal acts by clients. Another statement has been proposed that would require the auditor to inform management of significant weaknesses of internal

* A more technical definition is contained in Paragraph 110.01 of *Statement on Auditing Standards No. 1* published by the Institute in 1972:

> 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 the financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.

accounting controls discerned during an audit, thus making mandatory a practice now followed by most auditors.

The principal, though not the exclusive, purpose of the audit is to express an opinion on the financial statements prepared by management, thereby contributing to their credibility. Without the expectation that a disinterested party would test the reliability of the statements, management might be tempted to prepare its financial reports in a self-serving fashion. Thus, the independence of the auditor is critical to the process.

Also of importance in conducting a proper audit are such matters as the training of auditors, experience in performing audits, sufficient personnel (often audits of large companies require hundreds of professionals), supervision of the audit staff, controls to assure adherence to standards, appropriate reviews by persons not involved in the actual audit work itself, and other steps to remove as much as possible subjective elements from the process and the report.

The auditor's examination involves the use of various methods to secure information concerning the numbers and explanations reflected in the financial statements under review and the transactions which they summarize. An auditor could review every transaction, regardless of size, and obtain objective evidence of its elements—in effect, retrace transaction by transaction the entire operations of the company for the period under consideration. Obviously this would be inordinately expensive; simply reflecting on what would be involved to review one's own transactions during a year and to secure confirmation from external sources that each was properly recorded on one's financial records suggests what an overwhelming task this would be for a large business enterprise.

To prevent audit costs from being grossly excessive in relation to benefits, the accounting profession through the years has developed various methods of testing the information reflected in the financial statements. These techniques, while not giving the same assurance as an audit of every transaction, have provided in the combined experience of the profession a high degree of assurance in determining whether matters happened as represented. For instance, in testing the accuracy of accounts receivable reflected in financial statements, a standard procedure is to ask debtors whether the amounts shown on the books of the company being examined are accurate. From experience, auditors know they will not get a 100 percent response to confirmation requests; also, by experience, they know that with a sufficiently high response, together with other procedures, they may reasonably conclude whether the accounts receivable figure is reasonably accurate.

Similarly, they observe the counting of selected inventory items. With respect to reviewing some items, such as cash or marketable securities, a

more reliable determination can be made, because of their nature, by actual counts, or bank or depository confirmations.

Methods of external checking have been developed with respect to virtually every item subject to such verification in financial statements.

If, as can be demonstrated, auditing standards have through the years become increasingly demanding, how is it that there have been audits that did not detect and report that the financial statements were not properly prepared or properly reflective of transactions, that in some cases they concealed illegal management conduct and even fraud?

First, of course, auditing is done by human beings and involves a multitude of "judgment calls" with respect to such matters as classification of items, reasonableness of management estimates, *bona fides* of transactions, and the like; hence, there is ever present in the auditing process the danger of a human error, a mistake in judgment, a simple oversight—errors that can occur, and do occur, in every profession and every human enterprise and undertaking. While controls, training, and supervision may reduce them, errors are always possible in human endeavors.

In a number of cases, faulty financial statements resulted where auditing procedures to identify and test certain types of transactions, such as transactions between related parties, had not been developed because the phenomenon had not been widely encountered or a source of misleading financial statements; hence, individual auditors were not aware of the need to search for such transactions. In every such case where it has appeared that absence of sufficiently articulated auditing standards and procedures has contributed to a problem, the Institute's Auditing Standards Executive Committee has actively considered and issued pronouncements to provide the needed guidance. Even in the absence of business failures or misleading financial statements pointing to a problem, the Committee has, relying on the combined experience of the members of the Institute, issued pronouncements to head off possible problems.

However, of greater importance than human failure or a lack of standards is the danger of deception practiced by unscrupulous managements on the auditor in a way that defies discovery by even the most skilled investigator. These deceptions have been present in several of the allegedly "bad" audits.

The starting point of any audit is the books and records of the company, although this is not the end point, by any means. Thus, to take the simplest case, if a transaction was never entered on the books of the company, the auditor might only become aware of it through happenstance. In many cases, the misconduct which has been exposed was committed completely outside the books and records of the company;

hence, the auditor had no starting point. In other instances, the transactions were entered on the books, but the entry was misleading and misrepresented the nature of the transaction. For example, a bribe to a foreign official might have been labeled as a commission for sales services, a fact that could not be apparent to the auditor unless he interrogated the foreign official. Even then, he would not be likely to receive reliable information from the recipient of a bribe. Of course, if management colludes with a third party to mislead the auditor (as, for instance, by causing third parties to give false responses to auditor inquiries), the verification procedure is frustrated, and there generally is no practical way available to the auditor to detect such collusion.

In short, management fraud and misconduct are rarely, if ever, apparent on the books of the company. Artful entries usually are designed to have the appearance of being routine and proper to escape the eye of the auditor. In virtually every instance in which an auditor has been faulted, it has been the consequence of financial statements improperly prepared by management. In other words, the auditor, along with the investors, has been the victim of a management fraud—misrepresentation by the management of the company, deliberately concealed in some fashion from the auditor.

Some of these falsifications could be detected if audit techniques were extended beyond those now common. This would involve substantial additional cost, leading to the critical question whether the additional cost would be justified by the benefit to investors and creditors. Had procedures more explicitly designed to determine whether the sort of misconduct that has claimed headlines for the last two years been in use in the past, the cost to American industry, and ultimately consumers, might have been in the billions over the years. To date, out of some 10,000 companies that report to the SEC, about 300 have disclosed improprieties, including illegal or questionable payments. Some were not even clearly illegal or improper. The primary issue, then, is not the failure of auditors; rather, it is the cost American industry and American society are willing to bear to procure the benefits that would derive from a significantly expanded audit.

The principal purpose of auditors, particularly those of publicly held companies, is to provide an additional measure of credibility to financial statements for the benefit of investors and creditors. If an auditor finds evidence of illegality he has an obligation to apprise the appropriate people within the company of such fact and consult with counsel concerning possible other steps; if his legal duty is to inform others, then he must do so. The notion, however, that the auditor's primary function is the determination of the extent to which the audited entity has conformed to law, as suggested by the staff study, is indeed novel and at odds with the

entire history of auditing and the understanding of the business and professional community. The auditor is simply not equipped by professional training or otherwise to make the sort of sophisticated legal judgments such a distortion of his role would entail.

A number of projects are currently under way that will improve on the effectiveness of audits:

1. During the last session of Congress, and again in the current one, legislation has been introduced that would make it a criminal offense to misrepresent to an auditor, to fail to maintain adequate internal controls, to fail to maintain accurate books and records, and to falsify corporate accounting records. The SEC has proposed similar requirements by rule (Securities Exchange Act Release No. 34-13185). It might be noted that such requirements have been of long standing in other countries. For example, it has long been unlawful in Great Britain to make misrepresentations to an auditor. Obviously the dangers of criminal prosecution will affect the conduct of management; to the extent it does, auditors will be assisted and the effectiveness of audits will be improved.*

2. The Auditing Standards Executive Committee has adopted two Statements (Statements on Accounting Standards Nos. 16 and 17) to guide auditors in detecting and dealing with illegal conduct, management fraud, and the like. While these pronouncements are criticized in the staff study as inadequate, these criticisms are based on a misunderstanding of matters in the proposed pronouncements that have been clarified in the final pronouncements.

3. The Institute in October 1974 organized a commission under the chairmanship of Manuel F. Cohen, a former chairman of the SEC, "to consider how well independent auditors are meeting their present responsibilities, whether their responsibilities should be changed and how the nature and limitations of those responsibilities can best be communicated to users of the auditor's work" (*Statement of Issues: Scope and Organization*

* The Institute has favored making it a criminal offense for persons associated with a company under audit to misrepresent in writing a fact to an auditor; it opposed those parts of the proposed legislation which would have made oral misrepresentations criminal because of the uncertainties that attend such communications, and which would have extended the prohibition to third persons because of the danger that fear of criminal penalties would deter sources of information such as banks, debtors, and others from supplying information to auditors on a voluntary basis as they now do. The Institute believes the SEC's proposed rule designed to accomplish substantially the same results as the proposed legislation partially meets these concerns.

of the Study of Auditors' Responsibilities, p. 4). Only three of the seven members of this commission are practicing accountants. The others are a lawyer, a businessman, a financial analyst, and an educator. Notwithstanding that this commission had published nothing official beyond a statement of the questions it proposes to address, the staff study rejected the possibility that good will come from it (pp. 119-120). The contrary may more confidently be asserted. Preliminary discussions with the commission suggest that it will, indeed, recommend significant expansions of auditors' responsibilities and, given the times and the prestige and origins of the commission, its recommendations will be taken very seriously by the profession.

4. Virtually all firms, sensitive to the problems posed by the increasing complexity of business transactions and the rising expectations of the public, not to mention their own sense of professional responsibility, have tightened their quality controls, their supervision, their training, and their overall standards of performance. A random sampling of firms indicates that in the last five years the expenditures of such firms for quality control and training have at least doubled, while revenues from auditing have increased by between 50 and 70 percent.

5. The Institute has established a procedure and program for review of auditing firms by other auditing firms or by panels of other auditors appointed by the Institute, of the adequacy of the reviewed firms' controls, supervision, and the overall manner in which they conduct their audits and other activities. At this writing most of the large firms have arranged for such reviews, and it is expected that many smaller size firms will undertake such programs. The staff study seeks to disparage this program by stating on pp. 114-115 that the review of one major firm which had been disciplined by the SEC gave the firm a clean bill of health. The staff study neglects to mention that the review followed by some three years the first charge against the firm and that at least from the time of the first charge the firm had undertaken extensive measures to avoid problems; knowing that, it is not surprising that when the review was conducted it would justly find that the firm's standards and adherence to them were satisfactory. Obviously a firm conducting a review of another firm undertakes a considerable responsibility, one which could result in severe consequences if it concluded there existed no deficiencies in the examined firm and later the conclusion proved to be wrong.

6. In almost half the states, legislation has been enacted, largely at the instigation of the profession, requiring participation by accountants in continuing education programs as a condition of retaining their licenses; in all other states, the state CPA societies either favor such legislation or have voluntarily adopted such programs.

There is nothing in the staff study that would suggest that a governmental body developing auditing standards could more effectively mandate good supervision and control, thwart negligence and poor judgment, enforce more diligently compliance with accepted auditing standards and procedures, or deter more effectively management deception. An alerted profession is expending a great amount of its resources toward these ends and can be expected to continue to do this in the future. In fact, a governmental agency might be less effective, since it would not have as readily available the experience of the profession in identifying problem areas. Obviously, with the initiative and responsibility for the strengthening of auditing standards in the private sector, auditors are more alert to their responsibility to anticipate problems and, hence, are more willing to cooperate with the standard-setting group in developing standards that deal with potential problems.

3. Are auditors sufficiently independent of their clients?
(Recommendation 8.)

As mentioned above, integral to the effectiveness of the audit process is the independence of the auditors. The staff study maintains that auditors are not independent of their clients for two reasons: (1) They sometimes perform services other than accounting and auditing for their clients, and (2) they have testified in an advocacy role before Congress and other governmental bodies in a manner favorable to their clients' interests.

The standards for independence are established and enforced by the Institute, the state boards of accountancy, the state CPA societies, and the SEC. In addition to the standards established by such bodies, many firms have additional procedures and rules governing permissible and impermissible relationships. These are rigidly enforced using very thorough and sophisticated systems.

Independence essentially is a state of mind and not something that can be measured with precision. The SEC in Accounting Series Releases (Nos. 2, 22, 44, 47, 81, 112, and 126) and the profession's Code of Ethics and attendant literature have articulated stringent standards proscribing certain activities and relationships of auditors with clients. These standards serve a twofold purpose: First, they prohibit relationships that might, in the common experience of men, prejudice the judgment of an auditor; and second, compliance with them provides some measure of external evidence that an independent relationship exists. Of course, notwithstanding these strictures and their enforcement (the SEC has been extremely unyielding in enforcing its requirements), it is possible for various reasons that an auditor's judgment may not be wholly objective. However, it is noteworthy that, with extremely few exceptions, the cases brought against members of the accounting profession in recent years did not suggest the slightest evidence that any auditor had any of the forbidden relationships, had his judgment suborned by accepting any benefit from the client other than customary fees, or had in any other way permitted his independence to be impaired.

In the preparation and review of financial statements there are inevitably going to be matters as to which reasonable men differ, and in the life of an auditor there will be occasions when management personnel will for a variety of reasons urge strongly on an auditor the propriety of their proposed accounting judgment as opposed to that which the auditor thinks is right. These disagreements would exist even if every accounting principle were clear, even if every situation were governed by a single principle, and even if auditing standards and procedures anticipated every problem. Even if the staff study's recommendations were fully implemented, all elements of judgment would remain, and there would continue to be questions such as the estimated life of physical assets, the extent to which matters were material, the allowances which should be made for bad debts, the accounting period in which certain types of income should be recognized, and so on.

When disagreements arise between management and the auditors, they are sometimes resolved in a manner that is satisfactory to both parties. This is not, as suggested by some, *prima facie* evidence of a lack of independence on the part of the auditor; it is almost invariably the consequence of deeper inquiry by the auditor into the facts, and thoughtful response by both parties to persuasive arguments.

Notwithstanding a praiseworthy record of independence, various measures are being taken to strengthen even further the independence of auditors:

1. The SEC requires that when there has been a change of auditors, there must be disclosure in a filing with the Commission of any disagreement between the auditor and management over an accounting principle or practice, financial statement disclosure, or auditing procedures (Item 4, Form 8-K). Thus, a management may no longer dismiss an auditor over an accounting disagreement with no publicity other than the presence of a different auditor's opinion in the next annual report. These filings are often discussed in the press. Obviously this requirement strengthens considerably the ability of auditors to withstand management pressures.

2. The increased incidence of litigation has unquestionably caused auditors to be more sensitive to the dangers of succumbing to pressures from management. With increasing numbers of investors alert to possible

deficiencies in financial reporting, every auditor realizes that the penalties for any departure from sound standards or any subordinating of judgment to that of a client may entail not only financial loss to his firm, but also professional disaster for himself and possibly criminal prosecution and even (as happened in a case recently) imprisonment.

3. The SEC has increasingly monitored the adequacy of audit performance and brought injunctive and administrative proceedings when it believed there had been shortcomings in the work of auditors. In recent years, the Commission has more frequently named accountants and accounting firms in injunctive actions and in administrative proceedings to determine whether they should be allowed to continue to practice before the Commission. Also, the discipline of litigation is not confined to the SEC. During this period, many suits were brought in the United States charging accounting firms with deficiencies in their professional work. Quite obviously the overhanging threat of SEC or private party litigation is a strong influence in directing the profession toward more stringent standards of independence, competence, and adherence to sound practices.

4. Increasingly, companies have set up audit committees as a part of the structure of their boards of directors. Such committees usually consist exclusively of outside directors. A recent report summarized in the *Wall Street Journal* (January 19, 1977, p. 6) stated that in the past five years, among 646 companies surveyed, the number with audit committees had increased from 42 percent to 93 percent. It is noteworthy that in 1967, long before the current concern with this question, the Institute recommended that companies establish independent audit committees.

The audit committee performs several functions. It provides a means by which the auditors can discuss candidly with outside directors problems they have discerned in the company, the quality of internal controls, pressures from management, improper conduct they have found, and anything else they think may affect the financial statements of the company. The members of the audit committee have the opportunity to assess the competence of the auditors, the adequacy of their procedures, and the strength of their independence. Both directors and auditors have expressed satisfaction with the functioning of these committees, and the evidence is persuasive that the presence of an audit committee in a company strengthens considerably the audit function and the independence of the auditors.

The importance of audit committees is underlined by the request of SEC Chairman Roderick M. Hills to the New York Stock Exchange that it modify its listing requirements to compel listed companies to have independent audit committees. In that letter, dated May 11, 1976, Chairman Hills said:

> The existence of an audit committee that meets privately with the outside auditors to discuss the scope of the audit, questions arising during the audit, including disputes with management, and that has access to the corporate financial information, is an important part of our effort to maintain the credibility of our system of corporate self-regulation.

In response to this request the Exchange has adopted an amendment to its listing agreement requiring that after July 1, 1978, each listed company have an audit committee consisting of directors independent of management.

5. As discussed above, firms have strengthened and are continuing to strengthen their internal procedures to assure the quality and independence of their auditing work.

The staff study asserts that the independence of accounting firms in performing audits is compromised because they render various consulting services to their clients in addition to accounting and auditing. Not only is independence not compromised, but in many cases the quality of the audit is enhanced. Often the performance of these services provides the firm with a better understanding of the company, the adequacy of its internal controls, the calibre of personnel, and other information which assists materially in the auditing process. Further, there is not in the staff study the slightest evidence that these activities have in any way actually affected the quality of financial reporting or the independence of any auditor.

The staff study charges that lack of auditor independence is further evidenced by the fact that accountants often testify before public bodies advocating positions that are favorable to their clients. Sometimes accountants testify explicitly at the request of clients. However, their testimony is the fruit, not of a client interest, but of a conviction born of experience and professional insight. When they so testify they are not tools of their clients. Clients are by no means homogeneous in their opinions on any subject; hence, quite often a CPA's expressed opinion may parallel the opinion of some clients but offend others. Therefore, the charge that they do this as advocates of client interests rather than from convictions concerning the issues is without basis in fact.

It is not surprising that in many instances professionals deeply concerned with financial matters would find their own views corresponding to those of some of their clients; to suggest that because they have such clients they should remain silent concerning issues about which they have expert knowledge is not only to deny them basic rights but also to deny public bodies the benefits of their expertise. The implication of the staff study would seem to be that, under the changes recommended, accountants

would no longer be allowed to express their opinions on matters they deem of public concern or that might affect them or their clients, a restraint we suggest Congress would be loath to impose.

4. Are the Institute and the accounting profession dominated by the large accounting firms?
(Recommendations 4 and 12.)

The staff study asserts that, by their domination of the Institute, the "Big Eight" dominate the FASB and the senior and other committees of the Institute. The charge of domination of the Institute is based on the assertion that, while CPAs associated with "Big Eight" firms are only 15 percent of the membership of the Institute, their participation on Institute committees is much higher. The relevant facts are considerably different. Among the members of the Institute only about 75,000 are engaged in practice; of these, about 27 percent are affiliated with "Big Eight" firms and about 33 percent are associated with the 15 firms discussed in the study. These statistics are roughly in the same proportion as representation on the Institute's Council, its ultimate policy-making body, in which "Big Eight" members are less than one-third, and the 15 largest firms' members number about two-fifths; and on the Institute's Board, in which "Big Eight" members are one-third.

It also is not surprising that the large firms participate in some of the activities of the Institute more actively than other accountants. Large publicly held companies, while sharing some problems and concerns with privately held enterprises, tend to have the full range of accounting and auditing problems, including some which are unique to themselves. Thus, it is to be expected that accounting firms which audit publicly held companies would be more willing to commit their personnel and their resources to the activities and committees of the Institute most concerned with those problems. Furthermore, because of their size and internal research capabilities, those firms tend to be better equipped to commit manpower to this effort than firms with smaller staffs.

Finally, to the extent that the large firms influence the activities of the Institute and its committees, nowhere in the staff study is there evidence that this has been adverse to the development of sound accounting and auditing standards or the public interest. There is no evidence that had the participation of large firms in the Institute been confined to an amount exactly proportionate to their membership, accounting principles and auditing standards would be any better; a sounder argument can be made that they would not have been as good because of the lesser availability of the personnel and other resources of the large firms which assist the work of the committees and the Institute.

The simple fact is that the "Big Eight" are eight distinct firms who seldom speak with a single voice. An examination of the firms' submissions to the FASB, the Auditing Standards Executive Committee, and the SEC in response to proposals by those bodies shows dramatically the varying views and approaches among the firms, often concerning very basic issues.

Similarly, the suggestion that the large firms dominate the FASB through the Institute is belied by the fact that the Institute, like innumerable others interested in financial accounting standards, routinely submits responses to the FASB's discussion memoranda and exposure drafts which are often at variance with the comments of the "Big Eight" firms. A comparison of those submissions with the final opinions of the FASB shows that often the suggestions and criticisms of the Institute are rejected by the FASB! Clearly, if the Institute were the minion of the "Big Eight" and the FASB were the slave of the Institute these divergences would not occur.

5. Are present standards for determining the liability of auditors to public investors fair and sufficiently protective?
(Recommendation 3.)

The staff criticizes the recent Supreme Court decision, *Hochfelder* v. *Ernst & Ernst,* and calls for its legislative reversal. In that case the Court held that for an auditor to have liability under Rule 10b-5 (the SEC's rule prohibiting fraudulent, deceptive, or manipulative activity), it must be shown that his conduct was worse than negligent; it must be shown that he had an intention to deceive, defraud, or manipulate.

First, it should be noted that this decision has no effect whatsoever on the liabilities that relate to the registration of securities under the Securities Act of 1933 for the purpose of public distribution; under that act auditors may still be held liable if they fail to establish that "after a reasonable investigation, [they had] reasonable ground to believe and did believe" that the financial statements included in a registration statement on their authority did not contain any materially false statement or omit any material fact required to be stated in the registration statement or necessary to make the statements made not misleading.

If an auditor knowingly participates in a client's fraud, or, according to some courts of appeal since the *Hochfelder* decision, if the auditor is reckless, he may have huge liabilities to investors. Thus, the auditor continues, even under *Hochfelder,* to have a significant exposure to liability. For example, recently the liability of the auditors in the *Equity Funding* matter was settled—after the *Hochfelder* decision—for $39 million.

Furthermore, the Supreme Court in *Hochfelder* did not determine the extent of the fault necessary to sustain a complaint by the SEC. Since *Hochfelder,* several courts of appeal have concluded that simple negligence is sufficient to sustain a complaint by the SEC alleging violation of the securities laws. Such actions, which can culminate in damaging injunctive relief, can have a profound impact on the reputation and prospects of an accountant and accounting firm.

Beyond that, when the question is not one of liability of the auditor to purchasers of securities in a registered offering, but rather the extent to which he should be liable to the vast number of people who trade securities in the market, there is a considerable question of equity and fairness.

The simple issue is this: Is it equitable, is it good policy, to subject an auditor to huge, perhaps even ruinous liabilities, as the consequence of a single negligent act? Accounting firms perform thousands of audits a year (over 10,000 audited financial statements are filed with the SEC annually, and it is estimated that the "Big Eight" conduct more than 65,000 audits annually). With only a few exceptions, these have provided significant protection to investors, creditors, and others who have the need to rely on them. Is it appropriate—is it fair—to make an accounting firm, made up of literally thousands of professionals, answer for the huge damages that may accrue as the consequence of the negligence of only one or a very few members of the firm?

The answer to this question was well stated by Judge (later Supreme Court Justice) Benjamin O. Cardozo in *Ultramares* v. *Touche,* decided by the New York Court of Appeals:

> 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. . . . The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

Interestingly, the proposal to make harsher the liability exposure of auditors belies the concerns expressed by the staff report about an alleged lack of competition in the profession. The harsher the liability standards, the less able are small firms to bear the risk attendant upon an audit. How many small firms could suffer a $39 million settlement, even if covered by insurance, and survive? Small firms report that they have increasing difficulty in securing adequate insurance because they are not well known and do not have the resources of large firms. Thus, harsher standards of liability may further force publicly held corporations to engage the larger firms.

6. Is there excessive concentration in the supply of auditing and accounting services to large publicly owned corporations?
(Recommendations 4 and 12.)

The staff study suggests that accounting practice is too concentrated in the larger firms and that the Federal Trade Commission and the Antitrust Division of the Justice Department should investigate this matter.

Modern economic history, both in this country and abroad, has been characterized by the growth in size of corporations; the reasons for and social desirability of that growth are beyond the scope of this discussion. The growth of accounting firms has paralleled that corporate growth for a simple reason: To audit a major international industrial company requires a large organization. For instance, the audit of General Motors requires examination of records and other procedures to be done in approximately 200 major accounting locations of which 150 are in this country and 50 are outside the United States. Even for a much smaller company, the auditor must conduct audits at dozens of locations in this country and overseas. Most firms having clients with operations widespread geographically have expanded their activities correspondingly, in large measure to maintain the efficiency, consistency, and quality of their audit. Simply put, most small firms, confronted with the audit of a major company, would not have the resources to do the work.

Thus, it is not surprising that as corporations have grown, auditing firms have grown, and those structured to meet the needs of large companies have attracted large clients.

The remedies suggested by the staff study for the alleged concentration would in many cases diminish the quality of the audit and increase audit costs substantially. It is suggested that the auditing firms be rotated periodically. At the present time it is common practice for firms to rotate the personnel involved in an audit to assure fresh insights and preclude the development of relationships that might impair independence of judgment. However, this is done in a manner that preserves the important continuity of knowledge of the company, its history, its personnel, and its audit problems. Understanding of the company, its internal controls, the way it keeps its books, its policies, and its personnel, is universally

regarded as essential to the satisfactory performance of the audit. For instance, an authoritative work on auditing states:

> The integrity and reliability of presentations in financial statements depend primarily on two things: (1) the effectiveness of the company's accounting systems and the controls over them and (2) the fairness of its management's estimates, valuations, and judgments reflected in the statements. Thus, an auditor must understand not only a client's accounting systems, but also enough about the client's operations, management, and economic circumstances to be able to judge the fairness of estimates, valuations, and other judgments made. He must understand at least the following:
>
> 1. Accounting systems in use.
> 2. Systems of internal control.
> 3. Accounting principles used.
> 4. Characteristics of the operations of the client company that could have a financial or accounting impact.
> 5. Management policies and practices that could affect the reliability of financial and accounting controls and decisions.
> 6. Characteristics of the business environment that could affect financial statements.
> 7. Legal constraints, both present and potential, within which the enterprise must function (Montgomery's *Auditing*, 9th ed., p. 6).

If auditors were rotated periodically, each firm new to a client would be at a disadvantage because of its lack of familiarity with the client and its financial practices and would need considerable time to achieve the knowledge of the company possessed by the replaced auditor. It is surely not without significance that in a large number of the suits which have involved auditors, the relationship between the auditor and the client had been of relatively recent origin. Rotation would deny the auditor the very valuable tool he acquires as he achieves familiarity with a corporation, its procedures, and its people. Furthermore, each time a firm is changed, there is the additional expense of the auditor's familiarizing himself with the client and its procedures, an expense which would have to be borne by the client (ultimately, of course, by the public).

Increasingly the selection of auditors is being delegated to audit committees, which usually consist either entirely, or almost so, of outside directors. The staff study suggests that shareholders elect auditors by voting on competing firms. However, an audit committee, in continuous contact with the auditors, will obviously be in a far better position to judge the auditor's performance than shareholders who would have a very limited basis on which to compare the current auditors of the corporation with a possible replacement.

Finally, contrary to the staff study's charges about concentration, the number of smaller firms in which Institute members practice has in the last six years increased from about 9,500 to about 16,000.

7. Is the disciplinary process that impacts the accounting profession sufficient?
(Recommendations 8 and 14.)

The staff study criticizes the profession for not being harsh enough in disciplining members of the accounting profession for misconduct.

With respect to the Institute's disciplinary proceedings, several circumstances must be borne in mind. The Institute is composed entirely of individuals; firms are not eligible to be members. Hence, its powers as a private organization are limited to members, and the Institute can only bring proceedings against, and impose sanctions on, individuals.

Second, the Institute, unlike public bodies, has no subpoena powers, no right to force people to testify, no right to demand the presentation of documents; it can, of course, impose penalties, such as suspension from membership, for failure to cooperate with a proceeding, but often important evidence is in places and hands other than those of members and is thus unavailable to the parties.

Third, the desirability of prompt action against errant members must be weighed against concerns for fairness. Usually, when allegations of improper or inadequate work by an auditor are made, the matter quickly becomes involved in civil litigation or SEC disciplinary proceedings, or both, or, less frequently, criminal proceedings (regardless of Institute action, of course, such proceedings, no matter what the outcome, have a remedial effect surely as effective as disciplinary proceedings). If the Institute sought to determine whether disciplinary measures should be taken before the proceedings pending in court or before the SEC were concluded, the evidence adduced in its proceedings and the conclusions reached would undoubtedly be used against the persons or firms involved in court. Conversely, if the determination were favorable to the member, they would undoubtedly be used in his favor. Similarly, the documents developed in the course of the proceeding would be subject to subpoena. Inasmuch as the standards which would be applied in a disciplinary proceeding to determine whether sanctions should be imposed and the rules for the introduction of evidence might differ markedly from those which

would apply in a proceeding before a court or the SEC, the use of such proceedings, their outcome, or any documents or testimony elicited in the course of them in other proceedings could work a distinct hardship on one side or the other in the litigation.

To avoid such a prejudice to parties, the Institute has had the practice of listing for ultimate determination any matter where it appeared at the commencement of or in the course of a legal proceeding that a member of the Institute might have been guilty of actionable conduct. The matter is kept on the list until a final determination is made about it. Thus, on the current list of the Institute there are 162 matters related to cases pending in court or before the Commission. Each of them will be subject to active investigation when the litigation is ended or the statute of limitations has expired. Because of the protracted nature of proceedings in court, many of these matters have been pending for long periods of time. Given the desire of the Institute to avoid the prejudice which might accrue to a party in litigation if it conducted its proceedings while litigation was pending, there is no means of avoiding the appearance of undue delay.

Of course, the Institute, which can, at most, expel a member from a voluntary organization, is not the only instrument for discipline in the profession. Disciplinary matters are also handled by the state boards of accountancy, since they are the only governmental authorities which license accountants and which can effectively suspend or terminate an accountant's right to practice. In addition, the SEC, through administrative and injunctive proceedings against accountants, exercises substantial disciplinary power over accountants involved with financial statements filed with the SEC. Thus, in considering the effectiveness of discipline of the profession, the entire skein of governmental, legal, and private discipline must be considered rather than a single strand standing alone.

Finally, of course, discipline is only one part of a total self-regulatory scheme which involves much more than simply punishing errant members. The accounting profession establishes educational and testing standards, which are stern and demanding, for admission to the profession and the right to practice; it establishes and enforces standards of independence; increasingly it requires continuing education as a condition to the right to practice; it establishes the rules governing how financial statements must be prepared and how they must be examined by auditors. Compliance with this variety of standards is in significant measure enforced by the profession. However, courts have frequently used them as measures of the adequacy of an accountant's performance, implicitly affirming by so doing, that the standards themselves are sufficient to protect the public interest.

8. Should the federal government refuse to engage for consulting work all firms that do auditing work for the government?
(Recommendation 13.)

The staff study recommends that the federal government engage to do accounting and auditing work only firms which do not render consulting services to the government. This, of course, is predicated upon the false notion discussed above that there is a threat to auditor independence when a firm does consulting work for an audit client. Contrary to this assertion, the fact is that such services afford the auditing firm an added opportunity to gain the knowledge and insight necessary for the best performance of auditing services. Further, it is obvious that performing consulting services for one agency of the government would not impair independence in an audit of another agency.

Professional services are rendered with varying degrees of competence. We would suggest that the public interest is best served if consultants are selected in each case on the basis of their respective competences for the work to be done; if an auditing firm is capable of rendering the best consulting work in a given area, the public would suffer by refusing the work to that firm because of an arbitrary rule excluding such firm because it also did auditing work for the government.

CONCLUSION

We submit that the foregoing analysis establishes clearly that the accounting profession is fully able to provide reasonable protection to the public in its reliance on audited financial statements. The adoption of the recommendations of the staff study would, in truth, hinder achievement of that objective and frustrate efforts now firmly under way, rather than further the protection of the public.

We urge that the Congress reject the staff study recommendations which would fasten on the auditing profession, and American business, an unnecessary, unwarranted, and undesirable governmental burden.

END