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WHOSE RESPONSIBILITY?

by
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[Introductory note: Professor David Solomons was born in London and was educated at the London School Economics. He is a fellow of the Institute of Chartered Accountants in England and Wales.

After professional experience in London, he joined the faculty of the University of London and became Reader in Accounting there in 1948. He became the University of Bristol's first Professor of Accounting in 1955 and left Britain to join the faculty of The Wharton School of the University of Pennsylvania in 1959 as Professor of Accounting. He was chairman of the University's accounting department from 1969 to 1975 and became its first Arthur Young Professor of Accounting in 1974.

He was on leave from the University of Pennsylvania during 1972-73 to direct the Long Range Enquiry into Education and Training for the Accountancy Profession, an inquiry which was commissioned by the British professional accounting bodies. His book-length report on this project, "Prospectus for a Profession," was published in London in 1974. His book "Divisional Performance: Measurement and Control" earned him the - American Institute of CPAs' award for notable contributions to accounting literature in 1969.

David Solomons was a member of the AICPA's Study on Establishment of Accounting Principles (The Wheat Committee) which led to the setting up of the Financial Accounting Standards Board in 1973. He was the American Accounting Association's Director of Research 1968-1970 and is currently President of the Association. He has held visiting appointments in the Universities of California (at Berkeley), Auckland and at IMEDE (Management Development Institute) in Lausanne, Switzerland. He was Visiting Erskine Fellow at the University of Canterbury in New Zealand in September-October 1976. Dr. Solomons's teaching activities have lain mainly in the areas of managerial accounting and controllership.

The recent report of the Commission on Auditors' Responsibilities (The Cohen Commission) recommends that responsibility for setting auditing standards remain in the private sector but be transferred from AudSEC to a full time Auditing Standards Board. Applying the model of the FASB to auditing has obvious attractions. But auditing and accounting are different and the machinery which is appropriate in one field may not be appropriate in the other. The Cohen recommendation deserves to be looked at critically.

Thank you, Dr. Mellman. I knew that whatever adjectives Dr. Mellman used in referring to my subject, he would certainly describe it as timely. The adjective timely, incidentally, was also used by someone who stood at this podium just a year ago and who also talked about auditing standards. On April 11, 1977, Maurice Moonitz delivered the last Emanuel Saxe Distinguished Lecture in Accounting of the 19761977 series. His subject was auditing standards. From the printed version of his lecture it appears that Dr. Mellman, in introducing him, referred to the timeliness of his topic. You may think that coming back to the subject of auditing standards only a year later, I lay myself open to the charge of churning up well-trodden ground. I feel called upon, therefore, to defend my choice of topic.

THE INSTITUTE'S SPECIAL COMMITTEE ON AUDSEC

In the first place, the question, who should be responsible for setting auditing standards, is indeed even more timely today than it was a year ago. It is only some two months since the final report of the Cohen Commission on Auditors' Responsibilities was published. The Commission's recommendations, as Dr. Mellman mentioned just now, included one to replace the present Auditing Standards Executive Committee by a full-time Auditing Standards Board. The Commission's tentative conclusions, which contained the same recommendations, had been made public early in April, 1977, immediately before Dr. Moonitz delivered his lecture. The American Institute of CPAs responded by setting up a special committee to examine all of the Commission's recommendations. That special committee rejected the proposal for a full-time board and called instead for a restructuring of the Auditing Standards Executive Committee (AudSEC). It suggested that another special committee be set up to study the restructuring of AudSEC in more detail, and that was done by a resolution of the Board of Directors of the Institute in June, 1977.

The special committee on AudSEC, as I shall call it, is made up of five former presidents or chairmen of the Board of the AICPA -- the title of the office was changed during the period spanned by their incumbencies -- and its chairman is Walter Oliphant. The Oliphant Committee arrived at its conclusions at the end of February, after a public hearing which it held at the beginning of that month, and its preliminary report was presented to the Board of Directors of the Institute at the beginning of March. The conclusions reached in that preliminary report were made public in the CPA Letter of-March 27, less than a month ago, and they also appear in the April issue (the current issue) of the *Journal of Accountancy*. The Committee's full report will be presented to the Council of the Institute at its Spring meeting early next month.

I have gone into these events at some length because I have become personally involved in them. I was not associated with the special committee on AudSEC during the earlier stages of its work nor while it was gathering evidence, but during the final stages of its deliberations, I was asked to work with it to help in the formulation of its report. I suppose it is just conceivable that my present involvement with the setting of auditing standards is not entirely unrelated to my membership on the Wheat Committee in 1971 and 1972 which led to some important charges in the setting of accounting standards. In any case, I have probably said enough to explain why I thought that I might have something useful to say about this subject tonight.

THE DEVELOPMENT OF AUDITING STANDARDS

To trace the development of auditing standards, we might go back to April 1917, when the American Institute of Accountants (as it was then called) issued a memorandum which was published in the Federal Reserve Bulletin under the title "Approved Methods for the Preparation of Balance Sheet Statements." There is no need to go in detail into the developments that took place during the ensuing twenty years after that publication. Clearly, the next important date is the McKesson & Robbins case in 1938 which created, to quote a phrase used by John Carey in his history of the Institute, a "crisis in auditing." Following on that case, in January 1939, the Institute appointed a special committee "to examine into auditing procedure and other related questions in the light of recent public discussion," and their report was adopted with modifications by the Institute members in 1939. By an amendment to the by-laws which took place at that time, the Committee on Auditing Procedures, the predecessor committee of what is now AudSEC, was established as a standing committee of the Institute. As a matter of fact it was not until 1966 that it became certain that that committee had the right to make binding pronouncements on auditing without having them approved by members of the Institute.

The next important date is February, 1941, when the SEC, in Accounting Series Release #21, made it a requirement that the independent accountant's report on financial statements filed with the commission should state "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances." I am not sure that that was the first time that the expression "generally accepted auditing standards" was used, but that date, February 1941

does represent a landmark, and the ASR prompted the Committee on Auditing Procedure to embark on a special study of auditing standards, as distinct from auditing procedures, on which it had been issuing pronouncements hitherto. Then the war intervened, and the whole activity came to a grinding halt. It started up again after the war, and in October 1947, the committee issued its *Tentative Statement of Auditing Standards -- Their Generally Accepted Significance and Scope.* It is here that nine of the ten broad auditing standards were set out. The nine were adopted in September 1948, and the tenth standard was adopted in the following year. Incidentally, 1948 is also worthy of note in that it was in October of that year that the committee, in Statement of Auditing Procedure #24, presented a "recommended revised short form of accountant's report or certificate," a form of report which is substantially unchanged to this day. Of course, if the Cohen Commission gets its way, it may not remain unchanged much longer.

We could spend some time discussing the distinction between auditing standards and auditing procedures, but I don't find that kind of quibble very rewarding; and in fact, when AudSEC issues its statements now, it is very difficult to say whether

they are dealing with standards or procedures. Since 1973, all statements issued by the committee have been called Statements on Auditing Standards, SAS's.

When the FASB came into existence, or when it looked as if it was about to come into existence in 1972 -- it did not in fact take over from the APB until 1973 -- the Institute reorganized itself, in readiness, so to speak, for the phasing out of the APB, which had been a senior committee of the Institute. In the course of the transition, the Institute adopted a divisional structure with a number of divisions, each division having an executive committee. It was at that time that the Accounting Standards Executive Committee came into existence as a new senior committee of the Institute, for the purpose, among other things, of providing input to the FASB; and it was at that time, also, that the Committee on Auditing Procedure became AudSEC, the Auditing Standards Executive Committee.

THE SOURCES OF AUDITING STANDARDS

Auditing standards have come into existence for a variety of reasons, and have been prompted by a number of different agencies, persons, committees and situations.' Sometimes, members of AudSEC itself have taken the initiative for having a matter placed on the agenda. SAP #39, on working papers, for instance, is an example of that kind of auditing standard. Other auditing standards have been prompted by the work of other divisions of the Institute, or other organizations outside the profession. SAP #42, which deals with reporting when a certified public accountant is not independent, resulted from an opinion on the matter of independence which was issued by the Institute's Committee on Professional Ethics. Activities of the Accounting Principles Board and the FASB have given rise to auditing standards. For instance, when APB Opinion #19 on reporting changes in financial position was issued, the auditing committee had to follow up with an auditing statement revising the auditor's standard form of report to give recognition to APB #19. I could quote other examples.

Several important auditing standards have been the result of initiatives taken outside the profession, and notably, of course, by the SEC. Just to give two examples, Statement on Auditing Standards #4, which was issued at the end of 1974, on quality control considerations for a fan of independent auditors, was a response to criticism from the Commission on the quality of audit practice. Another example is SAS #13, issued May, 1976, on reports on limited review of interim financial information. That was made necessary by ASR 177.

Litigation, not unnaturally, has given rise to a number of auditing standards. I have already referred to the important part played by the McKesson and Robbins case in the history of this matter. The Allied

Crude Oil case led to SAP #37. The Yale Express case led to SAP #41, issued in October, 1969, dealing with subsequent discovery effects existing at the date of the auditor's report. One of the most troublesome of the statements issued by AudSEC, SAS #6, which was issued in I *1975*, and on which I shall comment later because it took no less than six years to get it out, dealt with related party transactions and arose out of the U.S. Financial case. More recently SAS #16, which was issued only in January of last year, dealing with the independent auditor's responsibility for the detection of errors or irregularities, was issued by AudSEC after an inquiry by a special committee into the Equity Funding case. Finally, also in January of 1977, SAS #17, dealing with the illegal acts of clients, might be described as being the result of pressure from Congress and from the press. SAS #17 provides guidance for an auditor when apparently illegal acts by clients such as bribes, illegal political contributions, and so on, come to his attention. Obviously, these examples are merely illustrative, and not exhaustive

THE PRESENT ARRANGEMENTS

At the end of this lecture I intend to comment on the proposals which the special committee with which I've been working is making to deal with some of these problems. But before one can evaluate those recommendations, it is necessary to understand what the present system is and also to look at some of the alternatives which have been proposed.

The authority for the promulgation of generally accepted auditing standards, which are binding, incidentally, on the Institute's members under Rule 202 of its Rules of Conduct, is vested in AudSEC. The standards do not require clearance from the Institute's Council, and if other bodies within the Institute are considering pronouncements which bear on auditing, those too have to be cleared with AudSEC.

The committee has twenty-one members, all of them members of the American Institute. Twenty of those members, at the present time, are practicing auditors, and one is a professor of accounting. They are all appointed annually by the chairman of the Institute, with the approval of the board of directors. Normally they are reappointed twice after their initial appointments, so that normally they serve for three years but not more. There is, therefore a rotation, and one third of the members retire each year. All of the members serve part-time. They are expected to devote about one third of their time to the work of the committee. They are entirely unpaid; and generally speaking, they don't even claim reimbursement for their expenses. Of course, the unpaid time which these men give is not the sum total of the service which their firms give to the profession, because very often they are backed up by assistants and advisors and so on, and if you attend a meeting of AudSEC, as I did the other day, you will find that in addition to the members there will be quite a battery of advisors sitting in the background. Much of the work of drafting is handled by task forces, also entirely unpaid. Usually a task force has a member of AudSEC as its chairman. At any one time, there may be as many as twenty-five task forces at work.

The voting rule of AudSEC, like some other important Institute committees, is that it requires a two-thirds majority to expose a draft statement, or to approve a final statement. Each paragraph, incidentally, has to be approved by a two-thirds vote separately.

THE CASE FOR THE PRESENT ARRANGEMENTS

The present arrangements have their critics. You know that, and I shall say more about those criticisms later. But let us just consider, before we go on, what the strengths of the present arrangements are. The criticism that has been directed at the process of setting auditing standards has been relatively muted, compared with the criticism that has been directed to the FASB and its predecessor, the APB. Even Professor Briloff, whom I'm glad to see sitting in the front row here, and who has been eloquent in his criticism of the performance of auditors, has had relatively little to say about the auditing standards themselves, or the process by which they have come into existence. Let me quote from him. "If auditors had, in fact, recognized the significance of the term standards, in the phrase "auditing standards," there' would never have been a proliferation of litigation against the leaders of our profession for their dismal performance of the attest function." That statement is reproduced in a statement of his which is printed in *The Accounting Establishment,* the Metcalf Committee's staff study, although I believe the statement was originally made to the Moss Committee.

Professor Briloff goes on in his statement to the Moss Committee to criticize SAS #5 for what he calls AudSEC's 'pusillanimity' in its treatment of the meaning of "present fairly in conformity with generally accepted *accounting* principles" in the independent auditor's report. To be fair to the committee, one has to recognize that they were constrained by the present state of generally accepted accounting principles. Accounting principles are the concern of the FASB, not of AudSEC. And I think fair-minded critics will probably not share Professor Briloff's harsh judgment of the performance of AudSEC in its handling of "present fairly." If generally accepted accounting principles are such that financial statements do not clearly present financial information fairly, it is very difficult for AudSEC, dealing with auditing standards, to do a great deal about it. Let me add, by the way, since I'm taking on Professor Briloff here, that from an interview with him which was published in Barron's in April 1976 (also reproduced in *The Accounting Establishment),* I am not sure that he would have done better than, and maybe not as well as, AudSEC in dealing with this matter. Let me quote from that interview. At one point he says, "I want the auditor who is reviewing the economic events with respect to that enterprise, based upon his professional integrity and professional consciousness, to develop the financial statements which he believes will present the economic event fairly." At that point the interviewer interrupted him and said, "Okay, what's fairly?" And Professor Briloff replied, "At the moment, I'm willing to fall back on a negative response. The avoidance of the unfair, that which we can discern to be unfair." I don't believe that that holds out promise of dealing with "present fairly" more effectively than AudSEC did in SAS #5.

Maurice Moonitz, whom I've already referred to,. gave his verdict on the profession's performance in setting auditing standards in a monograph of his which was published by the American Accounting Association in 1974, called *Attaining Agreement on Standards in the Accounting Profession.* He was much more reassuring about the state of health of the profession in relation to auditing standards than he was in relation to accounting standards. Let me quote from that monograph. He says, "The existing set of standards is not perfect, nor is it necessarily the best in the world, nor are the standards, such as they are, meticulously observed by all practitioners in all circumstances. The record does show that the profession is able to generate the written expression of what constitutes generally accepted auditing standards. No one can claim that the set of standards does not exist; furthermore, when the profession wants to or has to, it can revise those standards and do so quickly. It also has on hand an enforcement mechanism that it can use if it chooses to do so. The organization is there, it works. "(1) That was Maurice Moonitz, and again, later in the same monograph, he says, in the same context, "The organizational pattern fits the task to be done. The process works."(2)

The Cohen Commission called for a fairly radical change in the standard-setting process, and I'll comment on that very shortly. They wanted to move from a relatively large, part-time, unpaid committee, to a small? full-time board. Yet their judgement on the present arrangements was not at all unfavorable. Again I quote, from the Cohen Report this time. "The Commission believes chat the auditing standards-setting process has worked reasonably well. Neither the Commission's examination of significant cases against auditors nor any of its ocher research has uncovered significant evidence that audit failures are generally traceable to deficiencies in existing auditing standards. Existing auditing standards could be improved, and many improvements are suggested in this report. However, the existing standard-setting structure appears quite capable of providing the necessary evolution. "(3)

Let me quickly sum what seem to me to be the strengths of the present arrangements. First, the setting of auditing standards is in the hands of auditors, and they surely are the people who are best equipped by knowledge and experience to assess the benefits and the costs of auditing. Again, if I can quote from the Cohen Commission, "No need has been established," they say, "for taking the auditing standard-setting function from the domain of the accounting profession. Such a drastic institutional change would involve substantial costs. It cannot be justified unless significant improvements are needed and can be expected to result from the change."(4) They do suggest a change, but they don't suggest taking the matter out of the hands of the accounting profession.

A second point in favor of the present arrangement is that it is backed up by Rule 202 of the Institute's Rules of Conduct and the authority of the AICPA is much broader, less potent no doubt but much broader, than that of the SEC. The SEC, after all, has jurisdiction only over about ten thousand companies. The jurisdiction of auditors, most of whom are members of the AICPA, is much, much broader than that.

The third point in favor of a large volunteer committee, though not necessarily as large as the present committee, is that the varied membership that you can get on such a committee can bring to bear on these very technical problems a large number of highly skilled practitioners, drawn from a wide spectrum of firms of all sizes and with all kinds of backgrounds. And if you need a large number of subcommittees and task forces, that relatively large membership is a real advantage. Of course, there will be a point of diminishing returns where increasing size gives rise to increasing problems of communication and effectiveness. It is fairly widely felt that the present twenty-one man AudSEC is too large, and one of the proposals of the special committee calls for a reduction in its size.

A fourth point is that if standards are to be effective they must command widespread support; and they are likely, I suggest, to do so if they are developed within the profession rather than imposed from outside, even if that imposition is by a group within the profession which stands apart from and is not one with those who must apply the standards.

SOME CRITICISMS OF THE PRESENT ARRANGEMENTS

Now let us look at the other side. What are the criticisms of the present arrangements? The Cohen Commission noted that "in contrast to the amount of criticism generated by the accounting standard-setting process, suggestions for change in setting auditing standards have been infrequent."(5) The reason for that, no doubt, is that there is a relative lack of public interest in auditing standards as compared with accounting standards. Nevertheless, we must recognize that there have been critics who have suggested weaknesses in the present system.

The Commission's first criticism is that "present guidance on the application of auditing standards to audits of different size entities is inadequate." (6) I don't propose to say more about that except that it clearly does not constitute a case for a radical, structural change in the kind of committee that sets standards. It is something that the committee can rectify, if it needs rectification. The Institute has already set up a separate committee, the Accounting and Review Services Committee, to take on responsibility for dealing with unaudited statements and various other kinds of review which stop short of audit. Incidentally, small audit firms are quite well represented both on AudSEC and on the new Accounting and Review Services Committee, so that there is no reason why small businesses should be neglected when auditing standards are under discussion.

The Commission then raises another criticism. "Many pronouncements could usefully provide more specific guidance....There appears to be a tendency to make the guidance as general as possible." (7) They go on to give examples of what they mean by that. No doubt there is some substance in that criticism. But it clearly must be a matter of opinion as to how far an auditing standard can usefully go in giving specific directions. If it doesn't leave room for professional judgement there will be grounds for criticism on that score. It has been pointed out many times that standards are not textbooks, and a standard-seeing body like the old APB, and like the FASB, is constantly gingerly balancing itself on the very thin line between excessive generality on the one side and writing a cookbook, as it's usually called, on the other. Again, I don't believe this criticism by the Cohen Commission calls for major surgery, and some of the proposals of the special committee as I shall show shortly, will take care of that criticism, to the extent that there is substance in it.

The Commission goes on, in the course of its discussion about excessive generality, to suggest that AudSEC's reluctance to be specific is due to the view that innovations in auditing are proprietary matters, and chat firms are anxious to retain any competitive advantage that they may have, if they think they have developed a new method or a new approach to auditing, and may want to keep it to themselves. The Commission says: "Many, if not most, of the technological and methodological advances in auditing have in fact been developed by auditing firms." That, of course, is a rather strong argument for leaving the seeing of auditing standards in the hands of auditors, if that in fact is where innovations and developments have come from.

Then there is the criticism that AudSEC is not sufficiently productive, chat it takes too long to get standards out, and that it fails to anticipate problems before they become acute. There's no doubt that some standards have taken too long to get out. Here again, the problem is to balance d e need for speed on the one hand and the need for high quality in the standards on the other. Some of the matters on AudSEC's agenda are very complicated, and without protracted consideration I doubt whether a high quality of standard could be developed. The classic case, which is always thrown up in the face of AudSEC is SAS #6, dealing with related party transactions. This actually took from February, 1969 to July 1975 to promulgate. The explanation for that, if you look into it carefully, is that in fact the problems there were not auditing problems but accounting problems. There are no accounting rules for handling transactions between related parties. There are no accounting standards for the measurement and the disclosure of transactions which are not entered into at arm's length. There's much more that could be said about that. It should not have taken six years to deal with the problem; but it was, indeed, a very complex problem.

As for the alleged failure of AudSEC to anticipate problems and to recognize emerging problems, that's always an easy charge to throw at a committee, and a very difficult charge to rebut. I believe that one of the proposals of the special committee can go far to deal with that, and I shall comment on it later.

The final criticism voiced by the Cohen Commission is concerned with the quality of the members of the standards committee and of the staff. They are particularly critical of the fact that members of the committee normally may not serve for more than three years. They say there's a loss of momentum there. That, too, is a matter which is easily rectified without turning the committee into a full-time board.

THE BURTON PROPOSAL

In the current (April) issue of the *Journal of Accountancy,* there is an extremely interesting article by Sandy Burton, one of AudSEC's severest critics, on the profession's institutional structure in the 1980's. In that article he presents his plan for what he calls a "legislatively sanctioned self-regulating body," NARAF, the National Association of Registered Accounting Firms. Let me quote a passage in which he refers to auditing standards. "In general," he says, "the standard-setting mechanism has not resulted in an innovative approach to the auditing function, but has tended to enshrine or justify current practices. Recent auditing standards have emphasized protection against litigation, and their consideration by AudSEC has been heavily influenced by participation of legal counsel for the major firms. AudSEC has been hesitant to increase auditors' responsibilities, except under pressure from outside forces." Here again we are in an area where judgements may legitimately differ. There is a real question as to whether it is part of the responsibility of a standard-setting body to increase the auditors' responsibilities. It would be relatively easy for them to do so, although without the backing of the SEC, they wouldn't get very far. But one can well imagine that vigorous action from within the profession to expand the scope of its work and its responsibilities, with a corresponding increase in its fees, would at once be met by accusations that such actions were self-serving.

It is impossible for any socially sensitive person not to share Sandy Burton's concern that the profession should be responsive to its social obligations, in the matter of auditing standards as in other respects. The question is whether the best way to improve that social responsiveness is by an extension of public regulation. Sandy's article in the journal is immediately followed by a rebuttal from Al Sommer, formerly a member of the SEC. He says that "Sandy Burton's proposal runs directly against the increasingly predominant current of American opinion which looks to a reduction in the level of existing regulation, abstention from the adoption of more regulation, unless the reason is extremely compelling, and a greater reliance on the subtler forces in our society to bring about evolutionary reform." I would prefer to try to work towards the achievement of the ends which Sandy Burton has in mind through the more modest proposals that the special committee has made. At least I think they should be given a chance before moving on to a more drastic system of regulation by a government agency or quasi government agency.

THE COHEN COMMISSION'S PROPOSAL

Sandy Burton's proposal calls for a body very similar to NASD, the National Association of Securities Dealers, which has the backing of legislation behind it. The Cohen Commission's proposal was less drastic than that. Their recommendation was simply to replace AudSEC by a smaller, full-time auditing standards board. The proposal comes as a bit of a surprise at the end of the chapter in the report dealing with auditing standards, because up to that point, they'd been reasonably congratulatory. Certainly they were not very critical about the work of AudSEC and the standards that AudSEC has issued. They seem to have looked around, seen that the APB had been replaced by the FASB, and then sought a symmetry between the full-time Accounting Standards Board and a similar full-time Auditing Standards Board.

The arguments which led the Wheat Committee to recommend the creation of the FASB included some which really do not have anything like the same force in the field of auditing. The principle argument for establishing the FASB as a full-time body, outside the American Institute, was the need that we saw for accounting standards to be in the hands of persons who would be independent, and who would be seen to be independent, of the interests of their clients. Now the need for those who set standards to be independent is not nearly so great in the auditing field as in the field of accounting. Private interests outside the profession are much less sensitive to changes in auditing standards than they are to the pronouncements of the FASB. If there is an independence argument at all, it probably rests on the ground that a volunteer committee may be unduly reluctant to vote for a standard which involves a change in the procedures used by the firms from which its members come. There is dislocation and expense which follows on any kind of change, and there may, therefore, be a bias against change. Of course, the costs of change are real costs, and they should be open of the considerations when you are considering changing a standard. But there are other and better ways, I believe, of protecting society against undue reluctance to change. One is to change the voting rule of AudSEC, which the special committee proposes to do, so as to make it easier to get a standard adopted, and more difficult, therefore, to oppose change. The other main proposal is for the creation of an advisory council about which I shall say a word in a moment.

There was a second reason for setting up the FASB in the accounting field in the form that it took. The APB was a senior committee of the Institute, and unless there had been a change in the bylaws, no non-members of the Institute could serve on it which meant that no non-CPAs could serve on it. So if you wanted to have an economist on the APB, you couldn't have had one without changing the bylaws. Of course that could have been done, but it wasn't. We thought that, unlike the APB, the FASB should be set up in such a way that skills other than those that were found among CPAs could be brought to bear on accounting standards. So far as I know; the FASB has not as yet had a non-accountant member, although it does have non-CPA members; but at least the scope for that broadening of the membership of the FASB there. Now here again, there is much less scope in the auditing field for outsiders to contribute to discussions of auditing than there is to discussions of accounting. There is very little interest in auditing outside the ranks of the profession, and it is rather unlikely that there are people outside those ranks who could contribute in a major way to the work of the setting of auditing standards. However, if there are such people, they should be brought in; and another proposal of the special committee would make that possible, without going to a full-time board.

The last reason I shall comment on for moving to a full-time accounting board was that there was a sense of crisis in 1970-71. There was a heavy backlog of problems and a great need to speed up the operations. There is not a great backlog of auditing standards waiting for consideration, so far as I know, and there is not a situation which cannot be, with a reasonable hope of success, handled by a streamlined AudSEC.

These are the fairly strong arguments against the Cohen Commission's proposal; and there are two arguments which reinforce them on the other side. One is the sense of alienation that may develop within a profession if one set of people makes the standards and a different set of people has to implement them. This is a situation which is surely best avoided if it can be avoided without great loss of effectiveness. And finally there is the very real problem of recruiting people of the right caliber to serve on a full-time auditing standards board. Even if you allowed a revolving door, if you allowed persons to go back to their firms after serving on a full-time board, the inquiries made by the special committee raise serious questions as to whether you would get enough high caliber people, even if highly paid, to divorce themselves from their firms for a short period of time to do this work. An auditing standards board is never likely to have even as much glamour as the FASB, to say nothing of the SEC.

THE RECOMMENDATIONS OF THE SPECIAL COMMITTEE

Now let me sum up the main changes in AudSEC which the special committee is proposing. Then you must judge for yourself whether they look like being adequate to meet the problems that exist. The problems that exist. Let me repeat that. We are not dealing, I believe, with a crisis situation; and although it is relatively easy for any committee to propose drastic changes, the onus of proof must rest on those who propose those changes.

First as to the composition and appointment of the new AudSEC -- it may well be called the Auditing Standards Board. The special committee proposes that it should be reduced from 21 members to 15, a number large enough to provide a variety of points of view, but not so large as to be unwieldy or difficult to control by its chairman. Any person who has had extensive experience of auditing, whether he is a member of the Institute or not, should be eligible to serve on that body. That would probably require a change in the Institute's bylaws. The special committee proposes that such a change should be put into effect.(8)

The chairman and the members of the board would be appointed for renewable one year terms but the normal term of three years which they now serve would be capable of extension by a second period of three years, that is six years in total but not more. Again there is a tradeoff here between having a period which is too short for efficiency and too long to provide enough turnover.

There is a proposal to change the voting rule. The present two-thirds majority of AudSEC perhaps does militate against change, makes it too difficult to get approval of standards which introduce changes. On the other hand a simple majority rule looks slightly perilous. The special committee is proposing that out of the 15 persons on the new board nine affirmative votes should be required. That is under two-thirds but just over a simple majority.

The Institute has already ruled that meetings of its major committees shall be open to the public and meetings of the new auditing standards board would certainly be open to the public, though no doubt there would be some matters that they would continue to discuss in private, such as procedural matters.

The Wheat Committee, you may remember, originally recommended that the FASB should not publish dissenting opinions in the way that the APB had done. The FASB has disregarded that recommendation and I believe they were right to do so. I think we were wrong on the Wheat Committee to recommend against publishing dissenting opinions. The reason was that we thought dissenting opinions diminished the authority of a standard. But I believe myself now that dissenting opinions are useful in clarifying the opinions of the majority as well as the opinions of the minority.

An important change proposed by the special committee is that members of AudSEC should receive compensation if they claim it and that they should normally be reimbursed for expenses. An unpaid committee clearly puts very heavy burdens on practitioners from small firms, and though Institute committees are now unpaid, so that this change in the rule which will permit this committee to be paid may cause some problems, it's a situation which I think the Institute should face up to squarely. If we are going to have a large part-time board, it should be possible for all segments of the profession to serve on it without great financial sacrifice, and to achieve that, payment for services is going to have to be introduced. In return for this payment, members of this committee would be expected to commit at least 50% of their time to its work.(9)

There are proposals for strengthening the committee's staff, for the appointment of a high caliber staff director, and for the appointment of a separate research director. The staff member designated as the research director would work closely with the task forces.

Perhaps the other main recommendation, and I think a yew, important one, is for the creation of an Auditing Standards Advisory Council. How important this recommendation is will depend on the caliber of the people who serve. This idea has widespread support and I have no doubt myself that such an advisory council could contribute materially to the board's effectiveness. It could draw the board's attention to the need for new standards, it would review the board's agenda and express its opinion on priorities. It would of course review proposed pronouncements, it could provide suggestions for people to work on task forces and sub-committees. And, not by any means least important, it would be expected to report at least once a year, in public, on the work of the board and the extent to which it had fulfilled its charge and its obligations to society. The advisory council might have from between 12 to 18 members and, to quote from the Wheat

Report in connection with the advisory council that we recommended that the FASB should have, "the only qualification on the advisory council should be a capacity to make a contribution to the work of the Standards Board."

CONCLUSION

Let me close with a quotation, not from an accountant but from a lawyer. James Strother, writing in the Vanderbilt Law Review in January 1975 (his article presumably was written in 1974) on the establishment of generally accepted accounting principles and generally accepted auditing standards, had some things to say which really so well capture my own feelings on this matter that I would like to take a minute to quote from his article.

> "The involvement of the accounting profession in the establishment of professional standards has been a substantial public benefit, not only by virtue of the standards thus developed and improved, but also by serving as a focal point for the organization, recognition and development of the accounting profession itself. To a substantial extent, the rise of the accounting profession has been grounded on that involvement. A profession actively involved in the development of its standards will do a better job in their application. By their efforts, the American Institute of CPA's and the independent FASB have provided a reasonably coherent framework for accounting and auditing practice in areas that otherwise would have been subjected to fragmented or conflicting regulation. Despite the benefits deriving from their efforts, these private agencies by their nature must remain vulnerable to the risk of conflicting or competing decrees and regulations which could deprive them of their general acceptance and vitality. Their role and importance could be diminished should the SEC preempt or fail to support them. Similarly, these

> private agencies run certain risks if their contributions to the advancement and improvement of accounting and auditing are not understood and applied by governmental agencies, the Congress and the courts. At present there is no indication that either the AICPA and its Auditing Standards Executive Committee or the FASB face any substantial risk of preemption or lack of support. There is evidence instead that they continue to have the support they require. The process works more than reasonably well. "(10)

Strother wrote that in 1974. It was published early in 1975. I believe it is as true in 1978 as it was in 1974 that, again to quote from him, "a profession actively involved in the development of its standards will do a better job in their application. The process works more than reasonably well."

QUESTIONS AND ANSWERS

Dr. Briloff:
With that quotation from the Vanderbilt Law Review of January 1975 I urge that each of you go back to that very same issue because if memory serves me, there's another article referring to the accounting profession under the title "We Often Paint Fakes".

Solomons:
By Professor Briloff.

Briloff:
David, for about an hour, and understandably you've been something of an apologist for the accounting establishment. Briloff, on the other hand will continue in his campaign against the. Mafia which is the acronym standing for the Major Accounting Firms in America. David, to begin with, with respect to some of these burning S.A.S.s, statements on auditing standards #5 on "fairly," #6 with respect to incestuous transactions, isn't that the one, transactions between related parties, 16 on bribes and the like. I maintain that all of them and many of these SASs are essentially CYA rhetoric, which stands for Cover Your Anatomy rhetoric. In almost everyone of these situations, I believe you will agree with me that an auditor with conscience and conscientiousness should have known, like in U.S. Financial, about the incestuous transactions that ought to be weeded out. Like with respect to Yale Express, where for about a year they realized that the statements that they had promulgated in '64 were fake but yet they played possum and kept quiet. You and I know, each of us engaged in any accounting litigation, of the ways in which the auditors permitted their independence to just go by the boards and where they permitted the client to bend them, and fold them, and mutilate them. We see it in the testimony very clearly.

But now you picked me up on the fact that I have expressed by commitment to the he concept of fairness and you called me on it. I will not define "fair". 2000 years ago someone was asked what is truth and you haven't answered it yet. If I were to ask you what is justice, you can't answer that yet. So it is with fairness. I will not answer it. However, David, if when you go through *Unaccountable Accounting, More Debits than Credits,* "We Often Paint Fakes," and if you don't share with me the view that what the auditor permitted to be perpetrated there was unfair, then I will doubt your standard of fairness. You and I know that when you go into the courtroom you are sworn to tell the truth, the whole truth and nothing but the truth. But they can't get you on that unless you tell an untruth. Then you will be persecuted or prosecuted for perjury, as you should be. So it is that it comes as something of a disappointment for a scholar like yourself, whom I love and respect dearly, to be picking up the challenge about someone who is committed to the idea of presenting fairly. And all he's saying by that is, "Look, auditor! When you see the unfair, exercise it. And with respect to numbers, whatever the-number is, 41 or 5000, about statements subsequently determined to be untrue, exercise it promptly." Not like in Yale Express, waiting a year. Or National Student Marketing, never telling, hoping maybe it won't come forward. David, I appreciate what it is that our colleagues in the profession are doing for purposes of self-regulation. But, as you know, my plea is not that there are problems with respect to the setting of principles in accounting or in auditing. It's the failure on the part of our own organizations to discipline effectively those who have gone awry and have erred seriously, where the aberrant colleagues are part of the accounting establishment. You heard it laid out at the last Saxe lecture with Anthony. No one has responded to it yet. It was laid out even more aggressively a week ago Friday at the Bentley College conference on business ethics. Dr. Daniel Sweeney, the head of the Ethics Division, was confronted with it directly. No response. Now what about the response for the self-regulatory process through the self-disciplinary process?

Solomons:
As one might have expected, that was a very eloquent statement. But I don't feel that there's really anything there I have to reply to. Like Professor Briloff, I'm all in favor of fairness. And like him, I deplore the auditing failures that he has written about so effectively. But that is not the matter at issue here. The question is whether you can write a better standard, for instance, on the subject of "Present Fairly" than AudSEC did. Of course, I'm sure it's possible to write a better standard. All I'm trying to say is that it's a very difficult matter and perhaps they didn't do such a bad job - not such a bad job as to deserve, perhaps, the adjective "pusillanimous." Abe, you are inveighing against auditing failures, which I'm perfectly prepared to do as well, although I'm not as well informed about them as you are, and I am talking about the problem of formulating auditing standards. Similarly, you are critical, perhaps rightly, of the profession's ethical machinery and the means for enforcing the rules that it makes. I don't want to get into that argument. I don't need to. What I'm concerned about here is the machinery for setting auditing standards and all I've undertaken to do here tonight is to examine the pros and cons of different ways of doing that. No one has suggested, and I don't believe you suggested, that the serious auditing failures to which you have drawn attention have been the result of poor auditing standards.

Footnotes

(1) Moonitz, p. 7.

(2) Moonitz, p. 76

(3) Cohen Commission Report, p. 128

(4) *Ibid.*, pp. 127-128.

(5) *Ibid.*, p. 132.

(6) *Ibid.*, p. 133

(7) Ibid.

(8) The AICPA Council in May 1078 rejected the recommendation to open AudSEC to non-members of the Institute.

(9) The AICPA Council in May 1078 rejected the recommendation to remunerate members of AudSEC routinely.

(10) James F. Strother, "The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards," *Vanderbilt Law Review, Vol. 28, No. 1,* January 1975, pp. 232-233.