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## **The Work of the Commission on Auditors Responsibilities**

Manuel F. Cohen

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## THE WORK OF THE COMMISSION ON AUDITORS' RESPONSIBILITIES

by  
**Manuel F. Cohen, Esq.**  
**Partner, Wilmer, Cutler & Pickering**  
**March 8, 1977**



[Editor's Note: We are saddened to report the untimely death of Mr. Cohen on June 16, 1977.

Introductory Note: Manuel F. Cohen, Esq., is an attorney and a partner with Wilmer, Cutler & Pickering in Washington, D.C.

Mr. Cohen was a member of the staff of the Securities and Exchange Commission from 1942 until 1961 when he was appointed a commissioner. He served as Commission chairman from 1964 to 1969. He has also served as a Research Associate of the Twentieth Century Fund; Member of the Council, Administrative Conference of the United States and is a Professional Lecturer in Law at George Washington University.

Mr. Cohen has also served as Adviser to the American Law Institute -- Federal Securities Code Project, Chairman of the AICPA Commission on Auditors' Responsibilities, and Chairman of the Advisory Board of the Bureau of National Affairs. Mr. Cohen's memberships include Board of Editors, New York Law Journal; American Bar Association; Federal Bar Association; D.C. Bar Association; American Law Institute; American Society of International Law; The Academy of Political Science, and The International Bar. He is also a member of the Washington, D.C. and New York bars.

Mr. Cohen has published extensively in various legal and business publications in the United States and abroad.

The accounting profession has been the subject of considerable attention in recent months as evidenced by the Moss Subcommittee of the House Interstate and Foreign Commerce Committee and the recent staff report prepared under the aegis of Senator Metcalf, who is chairman of a subcommittee of the Senate Government Operations Committee.

Legislation suggested in the last session of the Congress, and more recent rulemaking initiated by the Securities and Exchange Commission, impinge upon the role, the work and the responsibility of the independent auditor and accountant. The Commission on Auditors' Responsibilities is charged with examining certain of the issues raised earlier in the areas of these activities of the Congress and SEC. It is within this framework that Mr. Cohen will speak about the work of the Commission.]

I am delighted to be here and to talk about the Commission on Auditors' Responsibilities. Indeed, I am going to give you an advance briefing on the tentative conclusions of the commission.

First, some background. The American Institute of Certified Public Accountants established the Commission on Auditors' Responsibilities in October 1974, to conduct an independent study of the role and responsibilities of independent auditors. The commission is the third independent study group sponsored in recent years by the AICPA. The first was concerned with the establishment of accounting principles (better known as the Wheat Committee). The second group studied and reported on the objectives of financial statements (better known as the Trueblood Committee). The commission on Auditors' Responsibilities is composed of seven members, four of whom, including its Chairman, are not professional auditors.

The members of the Commission were chosen to provide contributions from a wide variety of backgrounds and experience. Three members, a minority of the Commission, are professional auditors. Lee Layton, who recently retired as the managing partner of Main Lafrentz & Co., is a former president of the American Institute of CPAs and a former chairman of the Accounting Principles Board. Ken Stringer is the senior technical partner of Haskens & Sells. John van Benten is the managing partner of a midwestern regional CPA firm, George S. Olive & Company. Walter Holmes is chairman of the board and chief executive officer of CIT Financial Corp. William Norby, a chartered financial analyst and senior vice-president of a Chicago-based firm of professional investment advisors, is a former president of the Financial Analysts Federation. Lee J. Seidler, the deputy chairman, is a professor of accounting and a financial analyst and consultant. The chairman of the Commission fancies himself as a corporate and securities lawyer.

The staff of the Commission includes Professor Hank Jaenicke as principal research consultant; Douglas Carmichael, managing director, Technical Services, of the AICPA who is the research director; and Bob Temkin, a partner with Arthur Young & Co., who serves as staff director. Staff members from the Technical Research Division of the AICPA, several managers and supervisors with national accounting firms, and several professors at leading schools of business comprise the rest of the staff.

Although the independence of the commission has been challenged within these walls and elsewhere, I shall not attempt any refutation or explanation here.

Before I go into the specifics about the Commission's tentative conclusions, let me put all of this in a time frame for you. The Commission's report, which will be titled "Report of Tentative Conclusions," will consist of eleven sections plus two appendices. It will be published in late March. A public meeting will be held in June in Washington. After the public meeting and written submissions, the Commission will reconsider its tentative conclusions. I hope and expect that the final report would be published before the end of 1977.

I need not take much of your time to demonstrate the need for our study. The independent auditor faces a continuing challenge from many sources. Criticism in the financial press, the mounting disclosures of corporate scandals, and the astounding rise in litigation against independent auditors provide evidence of the challenge. Recently two Congressional committees have issued highly critical reports on the accounting establishment, if I may borrow a phrase.

Time does not allow me to take you through the Commission's report section by section except in the most incomplete and superficial way. Instead I will use a theatrical device and get to the heart of the report by going directly to Section 7 entitled, "The Auditor's Communication With Users," and use that as a takeoff point for the Commission's major recommendations. Many of the Commission's recommendations, perhaps its most important ones, are capsuled in a proposed new form of auditor's report and in the related

form of management report we recommend. The recommended form of auditor's report assumes adoption of many of the forty--odd recommendations made throughout our report. Those recommendations, if accepted, would probably be adopted over a period of time. Thus the new elements of the auditor's report would not all appear at once.

I should point out that our recommendations are directed to the profession, to its various organizations, to the FASB, the SEC, the corporate community, the universities and the Congress. The AICPA can act directly on some of our recommendations. In some cases the FASB or the SEC will have to take appropriate action. We are only an advisory group without authority to implement our recommendations.

Let me now take you through the suggested auditor's report. In so doing, I will comment on matters discussed more fully in other sections of the report. For example, the first paragraph of the illustrative audit report clearly notes that the financial statements were prepared by management. It also notes that there is an accompanying report by management, which is new and about which I will have more to say later.

The explicit statement that the financial statements were prepared by management has several implications that may not be immediately apparent. Section 1 of our report concludes that the auditor's role is to evaluate whether the financial information presented meets appropriate standards. In this role we believe the auditor should not report financial information (except to make up for management's failure to make required disclosures), or interpret the significance of the financial information presented. For example, a discussion and analysis of change in earnings is useful, but it should be presented by management, not by the auditor.

Nowhere in the illustrative report is there a statement by the auditor, now required, that accounting principles employed have been applied on a basis consistent with that of the preceding year or, when an accounting principle has been changed, to call attention to the change. Generally accepted accounting principles now require management to disclose a change in accounting principle. We believe that if the accounting and disclosure requirements have been met by the issuer, the auditor should not have to report -- that the basis has remained unchanged or that it has changed. By doing so, he crosses the line from evaluator to originator of financial information. We do not believe this is consistent with the auditor's role.

We recognize that many of our recommendations will require or suggest other changes, beyond our charge, in the area of accounting measurement or disclosure principles. We have not avoided those issues. Nor have we hesitated to suggest changes by others charged with that responsibility where necessary to implement our recommendations. For example, the Commission recognizes that users currently receive significant, if sometimes incomplete, information through the highlighting of changes in accounting principles in the auditor's report. To facilitate implementation of the recommendation to eliminate the auditor's reference to consistency, it would be useful for the Financial Accounting Standards Board to amend APB Opinion No. 20 to require a note to the financial statements covering accounting changes. The note should disclose all changes that materially affect inter-period comparability, including changes in accounting principles and changes in accounting estimates.

I will only hint at another implication of the clear assertion in the proposed auditor's report that the statements are management's, not the auditors. In Section 3 of our report, the Commission recommends that the "subject to" qualification related to uncertainties should be eliminated. The auditor has a responsibility to assure that full disclosure of material uncertainties is made to the reader of financial statements. But, the responsibility to make

the disclosures is management's. The auditor should not have the duty to call attention to disclosures that should be made by management. The auditor is not more capable than management in estimating the outcome of uncertainties. Reference to those uncertainties in his report might lead the reader to believe otherwise.

The second paragraph of the illustrative report omits the usual reference to "fair presentation." This is not a "cop-out." Our understanding of the phrase "in conformity with generally accepted accounting principles" appropriate in the circumstances places additional responsibilities on auditors beyond that understood by many, within and outside the profession.

We believe the phrase requires the auditor to make judgment as to the preferability among seemingly alternative competing accounting principles. I am sure that many of you are aware of the current controversy over the so-called "preferability issue." The SEC and segments of the profession are at loggerheads over whether the auditor should be required to state whether a change from one accounting principle to another is a change to a preferable accounting principle. Our view is broader. Section 2 of our report will state that the auditor has the responsibility to reach a judgment as to preferability even where there has not been a change in accounting principles or their application.

We do recognize, however, that there are a few instances in which preferability among alternatives cannot be judged, and we have noted those. The most obvious examples are in inventory valuation and in the various acceptable methods of determining depreciation charges. But we have taken the position that, in many areas where auditors have in the past disclaimed an ability to judge whether one accounting principle is preferable in the circumstances, the auditor does, in fact, have the ability to make that judgment and should be required to do so. I am not sanguine that this recommendation will be received without controversy.

To continue, Section 3 of the report makes explicit many of the implicit assertions that are in the form of auditor's report now used. For example, it refers expressly to the use of samples in the auditing process. Moreover, the recommended report, and the recommendations behind them, extend the auditor's responsibility beyond those he presently assumes. Thus, paragraph 3 includes the statement that there has been "a study and evaluation of the company's accounting system and the controls over it."

That sentence ties back to our recommendations in Section 4 with regard to the auditor's responsibility for the detection of fraud and in Section 6 on extending the boundaries of the audit function. In Section 4 a recommendation for a standard of care for fraud detection is developed. One of the elements of the standard of care is that the auditor should extend his study and evaluation of internal control beyond current requirements that he review internal controls only to the extent necessary to determine the extent of his audit tests. Section 6 suggests evaluation of and public reporting on internal accounting control as the next logical step in the evolution of the auditor's role.

We believe the proposed form of management letter to accompany the financial statements should comment upon the nature and strength of internal control and that the auditor should comment on weaknesses noted in the disclosures in the management report. In our view it is important that the auditor report material weaknesses in internal control to the proper level of management, including, if appropriate, the audit committee or the full board, and to the readers of the financial statements if management has not informed them of uncorrected internal control weaknesses. The auditor also has a responsibility to follow up in subsequent engagements to determine whether the weaknesses have been eliminated.

By this time, you know that our proposals envision an auditor's report that is quite different from the current standard one or two paragraph report. It is our belief, strongly supported by empirical studies, that the present standard report serves merely as a symbol. It communicates little to the reader, because it is a symbol and, as such, is rarely read. Merely lengthening the auditor's report and making its messages more explicit will, of course, not preclude the possibility that a revised report may become a symbol again. I should also note that, in many instances, the form of and control of the report we recommend will vary with the circumstances. We have provided for adaptation to the particular circumstances of the audit. This should help to assure that the full report will be read. In any case it will be impossible to determine the content of such a report merely by a quick glance.

The report also makes explicit to the reader a responsibility that the auditor already has for reviewing information, other than the financial statements, contained in an annual report or other document, and for comparing that information to the financials to determine whether there is any material disagreement.

We have also proposed inclusion of a statement that summarizes the auditor's responsibility with regard to interim financial information. The proposed report does not contain the current disclaimer of opinion on the interim information when the auditor now reports on his limited review of interim data.

Another paragraph is an outgrowth of our view of the auditor's responsibility for the detection and disclosure of illegal or questionable corporate acts. We have in mind those acts that have, since Watergate, been receiving a large share of the headlines -- bribes, illegal political contributions, payoffs to foreign agents or government officials, and the like. Section 5 of our report concludes that the primary responsibility for preventing, detecting, and reporting illegal or questionable acts should fall on the corporation through the adoption of an enforceable corporate policy on improper behavior and implementation of controls to prevent and/or to detect such behavior. The independent auditor should have an affirmative duty to search for illegal or questionable acts, but he should be expected to detect only those illegal acts that the exercise of professional skill and care would normally uncover.

In the area of *disclosure* of illegal or questionable acts, the auditor must take steps to assure himself that illegal or questionable acts discovered are adequately disposed of by the client. Illegal or questionable acts detected by the auditor should be brought to the attention of the board of directors. If the auditor concludes that the board of directors is indifferent to the problem, public disclosure is warranted.

I have used the phrase "internal accounting control" quite a bit. Of course, the auditor will not make the statement required in (the last clause of) that paragraph, as to the appropriateness of the design and application of the controls, unless he believes them to be true. Nor need I emphasize the stimulus thus placed on corporate management to take the steps necessary to enable independent auditors to make such a statement.

The last paragraph of our recommended form of report concerns the relationship between the independent auditors and the audit committee of the board of directors and ties into our recommendations in Section 9 for strengthening the auditor's independence.

In that section, we express the view that it is the process of appointing and changing auditors, rather than the fact of payment by the client paying them, that is critical to the maintenance of the independence of the auditor. We strongly encourage the appointment of audit committees composed of outside, independent members of the board of directors, and suggest that it is the board of directors, through its audit committee, rather than

management that should evaluate the relationship between the auditor and management. The board should have the final say in negotiating the arrangements for the audit, including the fee, and it should recommend the appointment of the independent auditors to shareholders. A strengthened and effective board, with enough independent members, is one of the most effective means of maintaining the independence of the audit.

I have referred to our recommendation for a report by management to bring together in one place many of our recommendations in other sections. Since I have already commented on much that would be in that report, I will discuss it briefly. This is not a completely innovative idea. AT&T does something very similar. However, our suggestions go beyond what AT&T is doing. Moreover, as I have already noted, the *auditor* would report on the adequacy of the disclosures in the report by *management*.

We suggest that the management report be prepared by the chief financial officer. The first paragraph of the proposal reiterates the view that the statements are management's and makes other assertions. The second paragraph addresses itself to the reasonableness of the system of internal controls, and summarizes the action that the company either has or has not taken with regard to the recommendations for improving internal controls made by the independent auditor. We have concluded that the current practice of many independent auditors in writing a so-called "management letter" suggesting improvements in the internal control system should be mandatory. A response by management to the auditor's suggestions would also be mandatory.

Another paragraph identifies the relationship between the company's attorney and the independent auditor with regard to material uncertainties and illegal or questionable acts. It establishes the primacy of management's role in preventing illegal or questionable corporate activities. The starting point for any auditor involvement in this area must be the willingness of management to prepare, distribute, and enforce a statement of its policies regarding activities that are illegal, unethical or against the best interests of the company. It also suggests that management should also explicitly state that it has done so. Management should also make a copy of its policies available to the stockholder.

The last paragraph of the management report would advise the stockholder of a change of auditors if that occurred before the publication of the annual report.

Developing an appropriate format and wording for the report by management will require considerable work. Substantial cooperation will be required between auditors and management. In the development of the management report this is similar to the cooperation now devoted to wording notes to financial statements concerning its responsibilities. The independent auditor might sometimes find it necessary to comment or take exception to elements of the report by management.

You have listened patiently. Even so, I have only skimmed the surface. I wish that I could have gone into much greater depth with you regarding the tentative conclusions that I have discussed here tonight; I also wish I could have covered many of the other areas addressed by the Commission. Our report will probably come to about 200 printed pages.

You will undoubtedly be informed by the AICPA and the press of the availability of our tentative conclusions sometime in late March. I can only assure you that the tentative conclusions will require your time and attention. But I urge you to struggle through it and to communicate your thoughts to us. I promise you that the Commission will be receptive to suggestions. The position papers we receive as a result of that exposure, and the testimony presented at the public hearings will be carefully considered.

Thank you for listening. I will be glad to respond to any questions that are not too difficult.

## SELECTED QUESTIONS AND ANSWERS

### **Question:**

Mr. Cohen, the impression that I get from your suggested report is that you remove some burdens from the auditor, but I do not detect what it is that you are inserting to replace them. It seems as if the totality of this burden will be lightened and a great deal will be shifted to management and to some other parties that serve management. I was wondering if you could elaborate on this.

### **Answer:**

I would be glad to, but first I must take issue with your summary. The report doesn't impose upon the auditor any additional burdens that he does not now accept and which he may never accept. I don't anticipate that this report will be accepted with the greatest glee by the profession, nor by the critics of the profession. In fact if it doesn't work out that way I know that something is wrong with the report. However, in terms of what may have appeared to you to be relieving the auditor from certain burdens, actually what we have done is to shift the current requirements or practice for dealing with certain matters in the auditor's report to the management where it has always been, but where management has not always really assumed it. Under our scheme of things, the auditor will have the obligation to review the management report where these things will be dealt with; and it seems to us more consistent with his role to evaluate rather than provide information.

But going beyond that, among the things that I mentioned, we recommended that the auditor have an affirmative responsibility to search for fraud and an affirmative responsibility to search for illegal acts and other questionable acts. We also have suggested that there be additions in the area of disclosure requirements. In connection with the financial statements, we suggested a number of special notes that are not now required as to which the auditor will now have a burden similar to that which he has today with respect to all notes that relate to the financial statements. Let me deal with the problem of preferability. I don't think that today the auditor accepts responsibility to reach a conclusion as to preferability and, in this connection, we go beyond the current SEC requirement which elicits information in this area only where there is a change. We think that the burden that the auditor should assume should apply in all cases whether or not there is an alternative, and I hope you will agree with me that this is a new departure. I hope you also agree that the affirmative obligation to search for fraud and for illegal unquestionable acts is likewise an addition. As to the present statement in the report that the financial statements present fairly in accordance with generally accepted accounting principles appropriate under the circumstances, we think that this is an obligation of the company and we have recommended, as a supplement to the usual financial statements, a management report which will make the representation in this area. And this will again bring into focus the auditor's responsibility not only to deal with the financial statements but with whatever other comments may be contained in the management report.

Some of these recommendations are directed to the corporate community, some are directed to the SEC, and others to the FASB; we tried to indicate as best we could that, in fact, the responsibility to improve the present situation is not solely that of the auditor.

### **Addendum:**

Now I would like to go on and deal with another subject which is a very important one and which I failed to cover. The Commission concluded that the audit function can and should be expanded to include verification of information of an accounting and financial nature that management has a responsibility to report, provided that the auditor has the

competence to verify the information and that it is produced by the accounting system. The Commission therefore recommends that the audit function should be expanded to include greater involvement in the company's financial reporting process on a more current and continuing basis. This expansion should begin immediately with a more comprehensive study and evaluation of the internal controls over the accounting system. The auditor's report on the audit function issued annually should include an evaluation of management's disclosure of information on internal control over the accounting system. The Commissioner also recommends the audit should be considered a function to be performed during a period of time rather than an audit of a particular set of financial statements, and that eventually the audit function should be expanded to include more important elements of the entity's financial reporting process. The Commission recommends that this expansion be undertaken gradually; first with expanded study and evaluation of the controls over the accounting system; then with a review of the process by which the company prepares quarterly financial information and other financial information releases regularly during the year. This expansion may not be new; it has been variously described as a continuous audit or the continuing obligation of the audit.

Let me also deal with this independence question because that is becoming once again an area that is a subject of considerable controversy. Since the auditor's independence is considered by the public, by users, and by the profession to be an essential ingredient in the auditors qualification, the Commission studied it very extensively. We took into account that in the United States, and most other countries having a private economy, the independent auditor is selected and paid by some one who is affected by his work. Total independence as a practical matter is probably a total impossibility. We tried to focus our attention on measures to assure that auditors would maintain the necessary degree of independence. We considered the present structure in the accounting profession as regulated by a combination of private and governmental efforts, including the courts and SEC. We also considered the possibility of alternate relationships such as government selection or payment of auditors and concluded that the present structure avoids the serious defect of politicalization of the audit function which might occur under government selection and payment. The Commission nevertheless concluded that the present relationship between the management and the auditor needed to be modified substantially to provide more support for the auditor's performance, since we believe that the process of appointment is critical to the maintenance of independence. We believe that the selection and the appointment of auditors should be transferred from the management to the Board of Directors, or the audit committee, and that the committee should evaluate the relationship between the auditor and management, recommend the appointment of the auditors and approve all the arrangements for the audit including the fees.

While we have found no evidence of the loss of independence in the performance of other services, the Commission recommends that the Board or Audit Committee evaluate the nature and extent of other services provided by the independent auditor, and that information concerning the nature and extent of such other services be provided by the auditors be disclosed in proxy statements.

We also recommended that the management of public accounting firms take steps to reduce pressures on independence arising out of too stringent time budgets and too restricted cost factors. We also considered the effects of competition within the profession. Furthermore, we recommended that arbitrary deadlines imposed by clients should be resisted because of their effect on independence and that steps should be taken to reduce or eliminate these pressures. Finally, we recommended that the SEC rules regarding disclosure when a change in auditor is made because of unresolved disagreements, or even resolved disagreements, on accounting methods be followed whether or not the auditors have been replaced.

**Question:**

I think the one thing that bothers me is that a little over a year ago, the chief accountant of the Securities & Exchange Commission, John C. Burton, spoke at a Saxe Lecture and advocated eliminating the myth that the financial statements are management's and accepting the fact that management and the auditor are preparing these statements together. Then let the auditor ask these questions: Would he have prepared these financial statements in that manner? Would he have valued the inventory under LIFO? Would he have used the double-declining method in computing the clients depreciation, etc.? I see a little difference between Burton's position and the position of the Commission, and I would appreciate some comments from you.

**Answer:**

Well I know Sandy Burton's point; he and I have debated it. I think I should say to you that when I told him what we are coming up with, he thought it was great. Not because it was a variant of what he suggested. He thought it was essentially the same thing. In fact, we do believe very firmly that the financial statements are the representations of the management and should be. I think it is important to maintain that responsibility. I think once you create a situation where the auditor becomes one of the persons responsible for the preparation and the presentation of financial statements, you have converted his role. I don't think he is independent anymore because, as you or Burton suggested, the auditor then becomes the person who prepares and presents those financial statements, and he is no longer independent. Nevertheless, our emphasis on his obligation to reach a judgment as to preferability of the accounting principles employed gets him almost to the same place that your suggestion would in terms of his obligation to see to it that management fulfilled its obligation by presenting the financial statements using accounting principles that are the most appropriate in the circumstances.

I indicated that there was something else I wanted to mention and some of you may be interested in it. We also have some recommendations in the area of the process of establishing auditing standards, and we concluded that the present Auditing Standards Executive Committee should be replaced by a relatively small five- to nine- member Auditing Standards Board within the Institute. The Board should be composed of members who serve full time and would be provided with adequate staff support. Participation by the profession in the development of auditing standards should be increased and changes should be made to encourage participation by others outside of the profession. The present rules of the Institute preclude participation in matters such as this by many professors of accounting who may not be CPAs. We think that the process is not fully served without their participation. We also recommend that more attention be given to public accounting practice involving non-public companies and to increase the quality and timeliness of the guidance provided.

**Question:**

Would you comment a little further to distinguish the role of the public accountant in reviewing internal controls and continuous internal compliance procedures?

**Answer:**

We think that the involvement of the independent auditor with respect to internal controls should be greater than it is today. He should have a responsibility in respect to internal accounting controls as they are commonly understood, and as I indicated, we believe it should be an affirmative responsibility which goes beyond the present requirements. As I understand it, the present requirements are that he must review those internal controls to determine the scope of his audit. We believe that it is important, particularly if independent auditors move to a more continuous association or involvement with the company on a continuing basis. We made some recommendations calling for a report on internal control

and internal auditing procedures at least once a year, but there may be occasions where the auditor would be called upon to do more than that.

**Addendum:**

There is one other great area of controversy between your profession and mine. I have already indicated that we believe the independent auditor has a duty to search for illegal and questionable acts and that he should be expected to detect those acts which the exercise of professional skill and care would normally uncover. We believe, however, that the corporation should bear the primary responsibility for meeting the demands of society with respect to corporate accountability and that it should adopt and publicize a statement of policies. I think I indicated earlier that once that is done the independent auditor would then be involved in monitoring compliance with such policies and his report could include his conclusions as to compliance with those policies.

We now come to the question of whether information as to legal claims and litigation should be modified or changed from the methods presently employed in conventional financial statements. We believe that it is in this area that society wants greater assurance than it has received heretofore with respect to matters which are essentially of a legal nature and that the lawyer should play a more important role than the auditor. Our suggestion is that in the management report the chief financial officer should indicate that, with respect to legal matters, he consulted with counsel with regard to the need for and the nature of disclosures to be made and included in the financial statements. The auditor would be responsible only for proper reflection in the accounts. This may go a bit too far. Those who may criticize it the most will be my brothers in the legal profession.

**Question:**

You touched briefly on the subject of establishing standards. You mentioned that the report may recommend that an auditing standards mechanism consisting of all full-time persons be designated within the AICPA. This touches on the very current question of who shall establish auditing standards and/or accounting principles. The recent Metcalf Report suggests, and indeed recommends, that the federal government and/or an agency of the federal government should promulgate auditing standards and accounting principles. Someone mentioned that about a year ago, Dr. John C. Burton addressed this distinguished lecture series and the question was put to Dr. Burton, does the SEC have a statutory authority to promulgate accounting principles and auditing standards? He answered very quickly and very affirmatively that the SEC does have that authority and always did.

My question is, why is the suggestion that the federal government and/or the SEC have the responsibility to promulgate accounting principles and auditing standards and procedures be considered so violent and so vulnerable when that authority has always existed and presently still exists? In fact, almost on a daily basis, the SEC does establish accounting procedures, such as Accounting Series Release 190 on replacement costs. And the Congress of the United States in its infinite wisdom even determined how the investment credit should be treated on financial statements. My question is does the Federal government or the SEC have the authority? And, if so, why is there a question raised as to their authority'?

**Answer:**

When I was at the SEC, my answer was yes to both counts, too. There is no question that so far as accounting principles are concerned, the Securities and Exchange Commission has ample authority to rewrite the rule books and rearrange things within reason. With respect to auditing, the Commission has from time to time indicated that it also does have authority in this area. However, there are those on the outside who question that last point. I don't think we need to debate that tonight because it is unimportant as we move to the second

point that you made: if we assume that the authority is there, why is the SEC reluctant to exercise that authority? Well, we have been involved in this for most of my adult life. I have to say to you that from the very beginning I thought the SEC was very wise. First, if I go back a bit in history, when the Security Acts were being considered by the Congress, one of the bills would have required government auditors to go out and conduct audits; and that necessarily would have encompassed writing the rules by government. The Congress was persuaded, I think wisely, that such authority should not be vested in the SEC.

The SEC decided early that it didn't have the resources or the experience, and while I sometimes hesitate to say it, I believe that my long experience in the government supports the wisdom of that decision. However, the situation isn't as nearly as black and white as most people might believe. In fact, as you said a few minutes ago, the SEC is a very important factor in the creation and maintenance of accounting principles. It has never been reluctant to establish a principle if the profession was dilatory in meeting its responsibility. Also it has not hesitated on occasion to take issue with the authoritative pronouncements which in turn led to changes in these pronouncements. I still believe, despite the criticism which continues to be levelled at the process and, in particular, against the FASB which has been in existence for only a short period of time, that we will have better accounting principles and that we will be able to enforce them more effectively if we do leave it to the private sector coupled with alert surveillance and concern on part of the government. I should also say that in our Commission on Auditors' Responsibilities we had the benefit of many points of view -- that of industry, the working profession, the academic profession and one lonely lawyer. We reviewed all this very carefully, and we determined that the current situation is the best that can be fashioned at this time. It may well be that if the profession through its organized bodies, whether it be the Institute or the FASB, does not set about in due course to take care of its many pending problems, then the question whether the situation should be changed will be reviewed again. I have no doubt about it. I really don't know what more to add except to say that the SEC has the power, it could exercise the power, but wisely it has not done so. Now in all fairness I should say that there is another body in the government the Cost Accounting Standards Board (CASB), which has developed cost accounting principles, policies, practices and procedures; and as far as I know, it has done a very good job. So I won't leave the impression that the government could not do a presentable job. I think, however, that apart from the matters CASB concerned itself with and because of the wide variety of matters of the accounting profession deals with on a continuing basis and the change that continues in our society at such a rapid rate, the private sector of the accounting profession can react more readily and more effectively even though every once in a while it needs to be prodded by a sharp barb.

**Question:**

If I understood you correctly a recommendation of your Commission would require disclosure of client relationships involving other than strictly audit services. To me this assumes that these are relationships that might compromise independence. Disclosure, therefore, does not make an auditor more independent; it just avoids the issue.

**Answer:**

Let me try to answer your comment in several ways. I should say at the outset this is a difficult area, and I did not talk very much about it. In fact, we do have some recommendations with respect to other services performed by auditors. One of them is the disclosure device, but we have some other recommendations on service which have a great potential to threaten the independence of auditors. I should preface what I have to say by stating that we really searched and called on everyone we could to provide us with evidence which would indicate that the performance of management advisory service had, in fact, jeopardized or compromised the independence of auditors. Now it may be the sort of evidence which is very hard to find, but we were unable to find it. Nevertheless, it is a

matter of principle, and it does seem as you suggest that when the auditor is placed in the role of advocate he is not really independent but becomes somewhat like a lawyer pleading for the client. We considered a number of different areas in which this occurs and in our report made some recommendations in this general area. In this connection, I went back to look at some old speeches I gave when I was chairman of the SEC. Fortunately, those speeches merely said that I recognized that accountants were more and more taking on various types of nonaudit services, and I indicated that I thought in some areas they were approaching a point where the work they did thereon might compromise their independence. I am trying to think of very specific situations where we thought services performed by an accounting firm would in fact compromise its independence. We had a great debate, for example, with respect to a matter of executive search; we had a great debate about accountants providing advice with respect to proposed acquisitions; and it is in these areas that you could get pretty close to the line. On the other hand, I can see nothing wrong on the part of a corporate executive who wishes to effect a corporate transaction and seeks out the best kind of advice of every kind -- legal advice, accounting advice, engineering advice -- so long as it is advice and not an involvement in the actual transaction. This is an area that should be watched.

