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Auditing Standards

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by
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[Introductory note: Maurice Moonitz is a Professor of Accounting at the University of California, Berkeley. He has also taught at the University of Santa Clara, Stanford, the Chinese University of Hong Kong and the University of Canterbury in New Zealand.

A California CPA, formerly with Arthur Andersen and Company, Professor Moonitz has served as vice-president of the American Accounting Association and also as chairman of its Committee on Accounting Theory. He was Director of Accounting Research for the AICPA, 1960-63, and a member of the Accounting Principles Board, 1963-66. He is active in the California Society, having served as president of the East Bay Chapter, 1971-72.

Professor Moonitz is a contributor to the periodical literature of accounting and is author or co-author of several books and monographs. He is the author of " Accounting Research Study No. 1, The Basic Postulates of Accounting," and co-author with Robert Sprouse, of " ARS No. 3. " He is co-author of an advanced text in accounting and in 1974 he published two monographs, one on "Changing Prices and Financial Reporting," and the other on "Obtaining Agreement on Standards in the Accounting Profession."

Since 1939 the organized profession, acting through the American Institute of CPA's, has formulated a comprehensive set of auditing standards. They have been reduced to writing and in large part adopted by the membership of the AICPA, so that they are binding on the members in their practice as independent auditors. Furthermore, the record shows that the profession can revise those standards quickly when it wants to or has to. A framework for the enforcement of these standards exists in the Code of Professional Ethics as well as a set of Trial Boards at both the national and state levels.

Despite this formal framework, much dissatisfaction exists with respect to the actions of independent auditors, manifested both in critical articles in the literature and in the litigation in the courts. This lecture will explore the possible reasons for the apparent lack of harmony between the formal organization and the asserted short-fall in performance by the profession. If the exploration is successful, we may be able to make suggestions for lessening the disparity between form and substance.]

It is indeed a pleasure to be here. This is at least my second visit to Baruch College, and under much better physical conditions than the first one, which was about fifteen years ago. I do not remember precisely where it was, but Dean Saxe was with me in the elevator. As I gave my talk, a basketball game was in progress on the floor above. My remarks were punctuated by some basketball star dribbling the ball down the floor. Tonight, things are in better shape.

While Professor Mellman was reading my biographical sketch, I realized how quickly events move because about six months ago one important item was published that was omitted from the sketch. I mention this item because it was co-authored by Reed Storey who is in the audience and is a former member of the Baruch College faculty. He and I made a joint study of market value methods for the valuation of investments in equity securities.

Dr. Mellman also made reference to the timeliness of my topic for tonight's lecture. It is timely. I did not anticipate the series of events that occurred recently, and in a very real sense I am not prepared to comment upon them. For example, I first saw the Cohen Commission Report last evening at 8 p.m., so I will only refer to it in passing this evening.

Now, to the substance of what I would like to say. My talk consists of two separate but related parts. In the first part I want to settle a score with an old friend, Professor Briloff. He and I have been at odds about the relative success of the accounting profession in establishing auditing and accounting standards. I have made the point that the profession has been successful in establishing auditing standards but not in its quest for a set of generally accepted accounting principles. Professor Briloff disagrees with respect to auditing standards. After trying to set the record straight, I turn to the main topic. By the end of the talk you will see that the two parts fit together.

On May 21, 1976, Professor Briloff made the following statement in his testimony before the Moss Subcommittee of the House of Representatives:

> *Generally Accepted Auditing Standards*
>
> Turning to the generally accepted auditing standards dimension of the GAAP-GAAS dichotomy, we find them enshrined in a compendium promulgated by the American Institute of Certified Public Accountants entitled *Statements on Auditing Standards.* Included therein are these principal categories (the prefixing numbers are those used in the compilation):
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> > 100 - Introductory
> > 110 - Responsibilities and functions of the Independent Auditor
> > 200 - General Standards of the Auditors
> > 300 - Standards of Field Work
> > 410 - Adherence to GAAP
> > 420 - Consistency of Application of GAAP
> > 430 - Adequacy of Informative Disclosure
> > 500 - The Fourth Standard -- that of Reporting
>
> At first blush we might be led to go along with Professor Moonitz's view that auditing standards, unlike accounting principles are insulated from outside pressures. He would have us believe that the general standards, the standards of field work, and the standards of reporting have gained such universal acceptance that they could be presumed to be firmly established. It may well be that the words are writ large and firm. As long as they remain as enshrined platitudes no one would or could argue with their validity. It is when the standards become operational that they begin to bend, stretch, shrink -- and sometimes wilt.

Briloff then goes on to mention some of the areas in which the standards did indeed bend, stretch, shrink, and wilt: real estate, franchisors and equipment leasing, business combinations, real estate investment trusts, land developers, and bank holding companies.

In *Obtaining Agreement on Standards in the Accounting Profession*, published by the American Accounting Association in 1974, I made the following statements:

> The focus of the inquiry is the *process* by which the organized accounting profession arrives at the rules to guide its members. A process requires some agency or entity to carry out the necessary steps. In the case of our profession the agency or entity takes the form of a committee or a board to consider the issues and make pronouncements. The formal organization must be appropriate for the task to be performed. Apparently the formal organization is appropriate for auditing standards; it is not, at least to this date, for accounting principles. (Page 2. Emphasis added.)
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> 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 at hand an enforcement mechanism that it can use if it chooses to do so. The organization is there. It works. (Page 7).
>
> Auditing standards, related procedures, and disciplinary actions are technical matters that can be established and enforced by auditors with a minimum of interference from laymen. Clients are interested in the size of the fee to be charged for the auditor's services. To that extent clients take an interest in the standards and procedures. The courts are definitely interested if the standards are so poor and the procedures so inadequate that the related financial statements are not true and fair or are false and misleading. But given the absence of obvious and notorious shortcomings and some accommodation on fees, outsiders will not take an active interest in the *process* by which auditing standards and procedures are established or changed. (Pages 60-61. Emphasis added.)
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> In contrast to auditing, laymen are most definitely interested in accounting principles, taken separately or in sets, because the reported results of operations of a business and its financial position are determined by the accounting principles it uses. The *process* by which these principles are set forth or are changed attracts the attention of many outside groups, but especially of management, which is responsible for the accounting employed by the company. (Page 61. Emphasis added.)

To specify what we are talking about, here are the generally accepted auditing standards:

> *General Standards*
>
> > 1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor. 2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors. 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

To judge by the events of the last 20 years, the following passage from Psalm 115 is worth remembering:

> They have mouths and speak not;
> Eyes have they, and see not.
> They have ears, and hear not;
> Noses have they, and smell not.
> They have hands, and handle not;
> Feet have they, and walk not;
> Neither speak they through their throat.
> (Psalm 115, Stanza 5)

Within the framework of "the enshrined platitudes" where did the standards "bend, stretch, shrink -- and sometimes wilt"? The first general standard (adequate technical training and proficiency as an auditor) has on the whole been observed, except in cases such as the Billie Sol Estes fiasco of some years ago and the Equity Funding scandal of recent memory. In both of those exceptional cases the evidence made abundantly clear that some of the auditors involved were ignorant of the rudiments of auditing. But at the level of the largest 100 firms in the profession, we can assume that the first general standard is observed in practice.

The second general standard deals with "independence in mental attitude." At all levels of the professional hierarchy, the evidence supports the finding that this standard has often been honored in the breach. We will have to return to this standard (i.e., independence) after our review of the remaining standards.

The third general standard deals with "due professional care" in the audit and the preparation of the report. Let us group this standard with the three standards of field work: adequate planning and supervision; study and evaluation of internal control; and accumulation of sufficient competent evidential matter. Again limiting our observations to the hundred largest firms in the country, the evidence accumulated by Briloff and others indicates that this group of standards has on the whole been observed in practice. In fact, many of the detailed cases indicate that the auditors knew what they should have known by any reasonable standard. The question to be answered, -- How could the auditors have been so blind?

We come now to the four reporting standards. The first, and by all odds the most important, is the requirement to state whether or not the financial statements "fairly present ... in accordance with GAAP." Oddly enough, the discussion of the first standard of reporting in *Statement on Auditing Standards No. 1* (AICPA, 1973) makes no mention of "fairness." Instead it leans on "conformity with GAAP.-" "Fairness" is mentioned in the first paragraph of the "Introduction" to SAS No. 1, and also in the discussion of the third standard of reporting, on "informative disclosure," but nowhere else. I found the same pattern in *Statements on Auditing Procedure No. 33,* (AICPA, 1963), the predecessor to SAS No. 1.

The second reporting standard refers to consistency, the third to informative disclosures, and the fourth to the need for an expression of opinion or a clear-cut denial, with reasons.

It is in this area of reporting standards, together with the general standard of independence, that we find the shortcomings of the performance of auditors at whatever level. It is in this area of reporting standards that we find the overlap between *auditing* standards and *accounting* standards. The reference to GAAP presumes the existence of GAAP and we know that the gaps in GAAP are both numerous and consequential. Tied in with the shortcomings with respect to GAAP is the shaky record with regard to disclosure. With few exceptions the improvements in financial reporting (in accounting, not auditing) have come about as a response to stimulus from the outside.

Here is how David Hawkins of the Harvard Business School summarizes the evidence:

> The financial disclosure practices of modern American industrial management have nearly all developed since 1933. Yet modern standards have sprung from an earlier reaction to the secrecy which surrounded the financial affairs of most 19th-century manufacturing firms. This reaction, which began around 1900, is the historical base upon which recent developments rest. Improvements in reporting practices came principally as the result of continuing pressure from individuals outside the managerial group for improved corporate publicity. The nonmanagement group included such diverse characters as the so-called critics of big business and leaders of the public accounting profession, and set the evolving standards by which the public evaluated corporate financial disclosures. The tempo of these critics' activities varied directly with the public attitude toward business, increasing markedly during those periods when management had fallen from popular favor.
>
> Persistently, management's financial reporting practices lagged far behind the externally set standards, since management favored corporate secrecy and the would-be reformers were powerless to force their recommendations upon managers. Eventually, because management generally had not voluntarily adjusted its financial reporting practices to society's evolving financial informational needs (as perceived by management's critics), amid the business

> disorder following the 1929 stock market collapse the federal government intervened in the field of corporate financial disclosure, in 1933. (David F. Hawkins, *Corporate Financial Reporting: Text and Cases*, Homewood, Ill., R.D. Irwin, 1971, pp. 34-35.)

When we put together the shaky areas of independence, of conformity to GAAP; and of informative disclosure, we define the area where, in all too many cases, the "platitudes" have not been reflected in practice.

For an additional perspective on the same scene, i.e., the sorry state of financial reporting, we can take a brief look at *Securities and Obscurities* by Ray Chambers, published in Australia in 1973. In his preface, he states, *inter alia:*

> One thing common to all the companies mentioned is that the financial information they published was seriously deficient in quality. This book strikes at that common element. Not because of the failures, losses and litigation that have befallen a relatively small number of companies; rather because prevailing laws and practices under them give rise, almost universally, to distorted representations of the financial results and affairs of companies.
>
> Drawing primarily on examples from the United Kingdom, the United States and Australia, the book shows that the existing practices, even of companies that are well esteemed, are inadequate, uninformative and often obscurantist. But often through no fault of their own. The practices that companies have adopted have generally been permissible under the statutes, regulations and technical rules of accounting of their time. The trouble has been that the laws, regulations and rules have been vague, toothless and often self-contradictory.
>
> The financial information on company affairs which flows to the securities market is the product, principally, of accounting rules. But we do not hold that accountants or their professional associations are alone responsible for the state of the rules. Managers, directors, stock-brokers, financiers, lawyers and others have also played a part, consciously or unwittingly, in bending and stretching the rules. We consider the consequences of this and find it in the interest neither of companies and their officers, nor investors and creditors, nor of the business community at large.

Chambers' remedy for this undesirable state of affairs is to change the rules, by legislation, and to change them to require his particular brand of current values as a basis for the financial statements.

What are some of the reasons for the apparent lack of harmony between the formal organization for the establishment and enforcement of auditing standards and the asserted (and documented) shortfall in performance by the auditors?

Independence. Not so many years ago, the profession viewed independence as a state of mind. Auditors were independent if they, in their own minds, knew they were independent of the client or of any other discernible external force or influence. Under this view, many auditors claimed they were independent when, for example, they served on the board of directors of a client or when they assisted a client in financial planning and control. I am of course speaking of those cases in which the auditor did the things mentioned and in addition issued an opinion on the same client's financial statements.

Under continual prodding from the Securities and Exchange Commission, among other forces, the profession changed its definition of independence in the early 1960s. The formal emphasis is no longer on the conscience of the auditor ("in my own mind I know I am independent"), but is now on "independence in fact" (SEC phrasing) or the way the situation looks to the outside world. This shift in the formal definition is about 15 years old; as you are no doubt aware, the shift in the heart and mind of the auditor is not yet completed from the older to the newer emphasis.

I also sense a connection between the changed attitude toward independence and the question of the fairness of the financial statements. Not so many years ago, at least one major accounting firm took the position that the standard audit opinion contained two central assertions, one, that the statements were "in accordance with GAAP" *and*, two, that the statements also "presented fairly" the financial position and results of operations of the client. As I have already observed, the formal statements of the AICPA on auditing standards now stress compliance with "generally accepted accounting principles" and barely mention "fairness" at a time when the courts and other agencies external to the profession itself are placing primary emphasis on "fair presentation" as seen by a reader or other user of the financial statements.

There are important cross-currents involved here. To mention just one, under the Securities Acts, management is primarily responsible for the financial statements; if they violate any of the prohibitions in the Acts, management bears the brunt of the legal or other disciplinary proceedings. Management knows this, and uses it to keep the auditors in their place. The auditors know it, and react in different ways to the situation.

The dilemma this creates for auditors does not excuse their shortcomings but it does help explain why they, unassisted, are limited in the steps they can take in those instances where they disagree on substantive grounds with their clients. One of the constructive steps that may come from reports such as those of the Moss and Metcalf Subcommittees of the U.S. Congress is a thoroughgoing review of the manner in which we regulate securities and the securities' markets. A modernized set of securities' acts could, of course, include provisions to make auditors more independent of their clients and therefore in a stronger position to make sure that financial statements do fairly present financial position and results of operations, and not merely that they are in accordance with a vague, inconsistent, and incomplete set of generally accepted accounting principles.

Rapid growth. In 1950 there were about 40,000 CPAs in the U.S. By 1960 the number had increased to about 70,000. By 1970, the number reached 115,000. Since then, the rate of increase has been substantial. According to the Metcalf Subcommittee of the U.S. Senate, the American Institute itself has over 117,000 members.

Individual firms have also increased dramatically in size. In the mid-1940s, Arthur Andersen & Company had fewer than 900 professional staff of all grades in its U.S. offices. Its most recent annual report tells us that as of September 1, 1976, its U.S. offices had over 7,500 professional staff, an eightfold increase in 30 years.

Rates of growth such as these for individual firms and for an entire profession must exact their toll. We do not yet have a serious study of the way in which the accounting profession in the U.S. managed this growth and the way it trained the newcomers; I will not try to make that study here and now. A few observations will have to suffice for the present.

For one thing, the formal training of entrants lagged behind the need. A few firms established training schools of their own, but they varied in format and quality all over the lot. In the 1940s, for example, only one (Arthur Andersen & Co.) had a centralized training school at its headquarters to which all new staff without prior experience were sent. A few other large firms had regional training schools. Later, the AICPA itself developed staff-training programs and offered them in various parts of the country, usually in conjunction with the local state society. This helped fill the need for the firms not large enough to set up their own in-house programs. Almost invariably and inevitably these programs stressed the technical aspects of auditing, and were uniformly too short to accomplish even that limited objective.

For another thing, the formal education of accounting majors in the post-secondary schools of the country failed to fill the void primarily because the schools tried to do too much in too short a time. A four-year undergraduate program is still the norm. In that period, we typically try to give students a general education for responsible citizenship, a broad background in business generally, and the fundamentals of accounting, and sometimes, of auditing. I make no apologies for what we have done from the side of the colleges and universities. We have done a good job in the time available. But the time available is too short for educating and training a professional. The legal profession found this out a long time ago. The accounting profession is just beginning to come to grips with the problem of professional schools of accounting and the major overhaul required in both accounting and non-accounting courses.

An obvious corollary to my remarks on formal education for entry into the profession is to point out that our entrance requirements are too low. We get many excellent people; we also get many who are marginal and often sub-marginal by any standards, except those of the CPA examination and the experience requirement. And in a period of rapid growth, who is going to take seriously a proposal to do something that will reduce still further the numbers eligible for admission to the circle of the elect?

A related need is for the profession to adopt methods by which to keep its members in tune with the increased and changing demands on accountants. Again the profession is responding, but weakly and almost certainly too late. I refer to the increasing number of states that now require evidence of professional development, usually in formal coursework or attendance at workshops and conferences, as a condition for renewal of the CPA license. This development is in the formative stage; the nature of the offerings that will satisfy the legal requirements are still not clearly specified. There is hope here for the future but no salvation for the past.

Another clearly visible result of rapid growth is the need for increased supervision, both in terms of time and the number of supervisory staff. But in a period of rapid growth, the seasoned, experienced staff is not there. Instead of limiting growth, however, the firms have followed the practice of rapid promotion, pushing the new managers or partners to the limit of their capacities, and beyond.

Individual firms have grown by merger in addition to natural growth. Expansion by merger in a period of rapid growth in the profession as a whole must compound the problem greatly. The most obvious result, exemplified most recently by Equity Funding, is unevenness in the quality of practice. The newly-acquired office carries the more prestigious name of the larger firm, but it still behaves in its wonted manner. And the problem of inadequate background in such cases is not restricted to the new entrants to the profession but to the whole professional staff, from green junior to seasoned partner. I am aware that unevenness in quality of practice is not restricted to a firm that expands by merger, but it must certainly be aggravated by that mode of growth.

I certainly have not listed all the consequences of rapid growth; I will not even claim that I have mentioned all the important ones. If the Cohen Commission on Auditors' Responsibilities has done its job properly, we will have a much better documented list of those aspects of audit practice that need change. Among those aspects will no doubt be many that can be tied to rapid growth as an important causal factor.

Deteriorating moral climate. What I have said so far is valid enough, but it still does not explain the shortfall in most of the spectacular cases analyzed so ably by Briloff and a handful of others. In most of those cases the fault lay not with the new entrants into the profession; it did not lay with the courses offered in the colleges and universities; it did not lay with the staff training programs or the professional development programs. The fault lies at the very top of the firms' hierarchy because the ultimate decision to go along with the clients' accounting and financial reporting practices was made at the very top. And the representatives of the organized profession itself (e.g., the AICPA and the state societies) are also at fault for responding so weakly to the demonstrated shortcomings of its members. As I have documented elsewhere, the profession itself has the organization and the agencies with which to act. And act they have not, except weakly.

This state of affairs points directly to a deteriorating moral climate within the accounting profession. The members of the profession have most of the tools they need to operate in a truly creditable manner, but on all too many occasions they lack the will to use them at precisely those times when to do so would tell the rest of society that the profession really means what it says about its high standards and especially about its independence.

Unfortunately, this state of affairs is not restricted to the accounting profession. If it were, society in general could discipline us or apply sanctions in some way and go on with its work. But the problem cannot be resolved quite so easily. We are all too keenly aware of the sad state of morality in the political sphere, even at the highest levels, so there is no need to belabor that point tonight.

However, let us take a look at an even nobler profession than accounting. What do you make of the following excerpt from a speech by Senator Daniel K. Inouye from Hawaii? It carries the title "Doctors' Image Worsens" and comes from the remarks he made at the graduation ceremonies at Tripler Army Medical Center, June 4, 1976:

> I have had to listen to the testimony of eminent physicians and surgeons charging that nearly one-third of our nation's hysterectomies are unnecessary, and many are criminally unnecessary;
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> That we have statistics that say that one out of every forty admissions to a hospital eventually results in injury due to overt negligence;
>
> That corrupt doctors have cheated not only the Federal Government but, more importantly, the helpless elderly patient by fraudulently inflating their payments due from Medicare and Medicaid, or by prescribing medications for patients that they have never seen;
>
> That our Senate Special Committee on Aging reports that from 20-40 percent of our nursing home drugs are administered in error;
>
> And that while we hear of the heroic efforts by organized medicine over the past 12 years to clean up its own house, in the next sentence we learn that of the approximately 345,000 practicing physicians in the United States, in 1973 only 12 lost their licenses and maybe an additional 100 more had some procedures brought against them.
>
> Your profession is faced with a number of critical challenges that must be resolved. And as one who has for a long time had great personal aloha and respect for your profession, I would submit that this is quite sad and

> depressing.
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> Surely the overwhelming vast majority of our men and women who comprise our nation's health care delivery system are individuals of great personal integrity and honor, men and women who look forward to carrying out their mission with dedication and enthusiasm. However, if this present situations persists, and if we continue to be exposed to sensational television documentaries, and graphic newspaper accounts of rampant greed and neglect, I am afraid that then legislative demogogues and an incensed public will force increasing federal involvement, and ever-increasing governmental supervision of our nation's physicians by various regulatory agencies.
>
> If our nation is to develop a viable national health policy (it) must first evolve from within our health professional community. However, if we are to avoid increased governmental dominance in the delivery of health services ... something drastic must be done by the members of your profession. In the Congress of the United States we have to date heard much talk about self-discipline and self-policing; about effective peer review, tissue committees and in-hospital continuing education programs. But we now need to finally begin to see some tangible results.
>
> I earnestly implore you today to actively do your part to improve our current deplorable situation, to do your part in bettering your profession's image in the public eye ... Your image has been sorely tarnished, and I wish you luck in your efforts to better it.

What can we do about it? Some years ago, my greatest success as a raconteur came from the following story: One day, the Lone Ranger and Tonto were riding up the canyon when ahead of of them they saw 25 Indian braves in full war regalia. They wheeled to the right -- 50 Indian braves confronted them. They wheeled to the left -- 75 Indian braves were there. They turned to leave the canyon only to find the way blocked by 100 Indian braves. The Lone Ranger looked at Tonto, and said, "What do we do now, Tonto?" And Tonto replied, "What do you mean 'we,' white man?"

Now, when I pose the question: "What do we do now?" I hope you do not answer, "What do you mean 'we,' West Coast man?" If we divide into those who are right and those who are wrong, we make it impossible to find a remedy. Instead we find ourselves in a confrontation, a situation already in process as the organized profession girds to do battle with the Federal government, as exemplified by the Moss and Metcalf Subcommittees.

Your distinguished faculty member, Abe Briloff, has suggested a Commission on Corporate Accountability in his recent book, *More Debits Than Credits.* In principle, I cannot object to such a Commission; it might even be a necessary condition for success in making auditors truly independent. But a Commission on Corporate Accountability reflects a reliance on organization to solve problems. I feel we already have the organization; if we do not have all the necessary conditions, we are close to that state of affairs. How do we infuse the spirit, the will to do better into the organism? How do we bring about the sufficient conditions?

With your indulgence, I propose to stop at this juncture in my prepared remarks and try to come to grips with a solution in the discussion period. Let us hope that we of the accounting profession are not in the state of the large eastern city characterized by Lincoln Steffens some years ago as "corrupt but contented." So -- who wishes to start the dialogue?

SELECTED QUESTIONS AND ANSWERS

Question:
I would like to address a question for your comments on the second principle of independence. What happens to that principle of independence when the big accounting firms are engaged in management advisory services? Secondly, what happens to it when all accounting firms are engaged in an adversary capacity when they interpret the tax laws?

Answer:
You do recall that I singled out independence as one standard which has been honored more in the breach than in the observance. The two questions you pose have been discussed and debated for many years. For my personal reaction, I don't see any particular problem in connection with tax practice. This is a kind of pragmatic judgment that is simply based upon an observation of what has been going on. I am disturbed by the mixture of management advisory services and granting of auditing opinions by the same firm for the same client. But the official position of course is that there is no conflict or at least no necessary conflict between MAS and the auditor function. Now, what's going through my mind right now is an experience I had when I was in Hong Kong. I was there for two years at the Chinese University. We started a graduate program in business administration, the first year; a dozen the second. The largest employer of labor outside of government in the Crown Colony of Hong Kong is the Kowloon Motor Bus Company. They used two auditing firms; one was Peat Marwick, the British firm; the other was Lown, Bingham and Matthews which was later to become a part of Price Waterhouse. Kowloon Motor Bus closed its books in February. The annual meeting of the stockholders was held in October. Why? It was held in October because they needed at least a month to get the annual report out to the stockholders. This makes some sense, but why did it take so long to get out the annual report when the auditors didn't finish until September? Why couldn't the auditors finish? Because the books weren't closed. Why weren't the books closed? Because the internal procedures were messy. In fact, what disturbed me even more was that management was not getting its routine reports on each month's operation until the 15th day of the second month following the close of the period. For example, management received the March report on May 15th. This was an impossible situation. Kowloon Moter Bus wanted me as a consultant. Why did they want me when they had two large firms as auditors? Because they would not help. They would not come in to help the client because it would impair their independence. I think they were going too far, because all that was needed was the simplest kind of data processing to expedite the flow of paper work in order to get the numbers together. They went to that extreme under the British influence. They would not help a client close the books in time so that the audit could be done. Over here it's a different attitude.

Question:
You spoke about adequate technical training and due professional care in the auditing standards, and you subsequently mentioned rapid growth. Now I am kind of jealous of students who graduate from this school or any other business school today ,and are told that within ten to eleven or twelve years they will be a partner; whereas way back when I graduated I was told I would be lucky if I were around twenty-five years later. Now, I have a great deal of respect for auditing, but I feel the only way you could learn it is by doing it; and it seems to me that many of the cases against the auditor would be caused by lack of training or lack of due professional care. Now there is this conflict of rapid growth, the ambitions of the young people, and the need to learn in the field. How do you reconcile these?

Answer:
Well, I think I can rephrase the point I was making. I'm always willing to reword if I don't

yield on the basic point. That's the essential element. If the only thing wrong with the auditing profession today was inadequate supervision, otherwise dedicated people who were trying to do the best thing under the circumstances, we wouldn't be in the mess we are now in. You are quite right; first place I think education for accounting is better than it was when you and I went to school. Certainly the training given by the firms themselves is better now than it was. These are relative things. You see, the figures I gave are extraordinarily large; and I think it is simply in a relative sense, the training both at the schools and on the job has not kept pace with the demands. You recall that I prefaced my remarks by pointing out that no one has made a serious study of the way in which the profession managed to hold together. Somehow, the point you are making certainly ought to be subjected to much more detailed examination than I've been able to give it.

Question:
(Briloff) Maury, at this time I don't know whether you came here to demonstrate the fact that you agree with me or disagree with me. I'm at just a wee bit of a loss. I would, however, agree very importantly with you when you refer to the fact that there's a lot of gas in GAAS. You suggested Equity Funding as being a manifestation of lack of capability -- incompetence on the part of auditors. I might also add Sterling Homex. I might also add the Investors Overseas Services, and I might also add the back office mess of Wall Street among many others indicating the lack of competence. On the score therefore, I urge that the American Institute of CPAs in their implementation of their code of professional ethics look into those actions as well as others to find out who within the firms permitted the incompetent things to prevail.

However, I want to come back to your major thesis that GAAS is capable of being determined and codified. I maintain that is something of a hang-up or a myth on your part and possibly the others. The very fact that the Cohen Commission had to be designated -- why they called it Commission rather than the Committee; I don't know. It had to be created -- that is indicative of the fact that they weren't able to determine standards. The fact that the Securities and Exchange Commission had to designate a committee on disclosure indicates that. The very fact that the profession can't agree on what the certificate means in terms of the emphasis to be put on the word fairness is indicative of the fact that once again, words are thrown around rather cavalierly. The very fact that the Financial Accounting Standards Board has still to try to ruminate as to what are the objectives of financial statements. To whom is the auditor responsible? For what and when is he responsible? The very fact that we still have amongst ourselves the buzz words of bribery and fraud and the auditor's responsibility for preferability. Now to me all of this means that the infra-structure of auditing has yet to be made somewhat solid and substantive. But, again, you know we agree, whether that would be in respect to GAAP or GAAS, it's not the words that are hard to find. It's the people to implement these important words. I know this is exactly what you turn to toward the end of your talk. I don't know whether you came here to agree with me or to continue the tilting, but I welcome either side.

Answer:
Well, on the first point: do I agree or disagree? I suppose basically I agree with most of the major points you have made -- at least in your published work. In the first part of my remarks I was clarifying something. My own interest in the area obviously stems from my three years with the Institute in the 60s working closely with the Accounting Principles Board which had been charged to narrow the areas of difference in general accepted accounting principles, and to set forth the postulates and broad principles of accounting. This is their language not mine. Now that did not come to pass. APB was not able to do it. After I left the Institute to return to Berkeley, this kept bothering me -- why was it so difficult to perform this task? And sometime in the late 60s, the light dawned on me. I was asking the wrong question. It wasn't a question of why it was so difficult to do these things.

Almost anything worthwhile is difficult. The real problem is that it's so difficult to agree on any set of accounting standards. Remember, in the 60s, we did not have many research studies. I was associated with ARS Nos. 1, and 3; Paul Grady produced an inventory of generally accepted accounting principles (ARS No. 7), which, with one major exception, described the practices of the time, good, bad or indifferent. Still, APB adopted none of them. In a search for an explanation of why it is so difficult to agree, I observed this differential behavior within the Institute itself between the committee on auditing procedure and the committee on accounting procedure (and its successors, APB and FASB). The auditing standards committee was able to complete its work and issue reports which were adopted in the early days by direct vote of the membership and later through the auditing standard executives' committee. So that good, bad or indifferent, we knew what the standards were that they were talking about. In the case of accounting principles, we didn't. I wanted simply to set forth the background and explain my emphasis on the process which to me is an important aspect, not to be lightly set aside. Now, the record I think will show, Abe, that in recent years the auditing standards committee has reacted perhaps unwillingly, perhaps somewhat too slowly, but it has reacted to some of these events; and has come out with standards the rest of us can debate, whether those standards are as good as we would like them to be. We have output from auditing standards committees stating what the stance of the Institute ought to be and how auditors ought to behave. We have no similar development in accounting principles. Nothing as successful in the sense of accomplishing the mission that the group itself set out to do. The substance of your comments -- I think the difference between you and me is on this extent of the differentiation between auditing and accounting. Obviously, the record does show shortcomings in both areas; particularly in cases you have analyzed in your published work; but a good many of those do not involve *auditing* standards except the reporting standards which cross over and actually embrace the whole problem of *accounting* standards. This is a peculiarity of the American scene, because the American auditor is required to state his opinion whether financial statements are in accordance with generally accepted accounting principles. The auditors in the British sphere of influence are not required to make any such assertion. The auditors in the British sphere are less concerned with accounting principles. The British rules require disclosure of the method used, but no further comment by the auditor, as long as the auditor is sure, in his subjective judgement, that the financial statements are true and fair, whatever that means in that particular setting. The cases you mentioned turn on this very important distinction between accounting principles and auditing standards.

Question:
The question I would like to raise to both you and Professor Briloff is as follows: we are now faced with what might be the first time in the course of American history where the legislature of the U.S. is going to tell us what the accounting principles and generally accepted auditing standards should be. Those of you who stayed awake till 2 o'clock last night listening to David Susskind will have found that there is a direct complication to this problem. If there will be such legislation, do you believe that the Congress of the U.S. will be capable of doing a better job than the profession has done today? If you do believe so, do you believe then that the profession will be able to exist or will we be all salaried employees of the state? I now have to give my social security number when I sign my tax return. I'm ready to roll up my sleeve for a tattoo!

Answer:
First of all, today we have no action by the U.S. Congress on these matters. We have a subcommittee report in the Senate. We have a staff report. I am not under-estimating the importance of these steps, but we are still a long way from legislation. Secondly, if we do get the legislation, we don't know its form. We've had no previous experience in this sort of thing. I also like to observe that you and a lot of others are assuming that it's either Uncle Sam or the Private Sector that will set the rules, that there is no other choice. This happens

to fly in the face of what's actually happening here and around the world. I'll go directly to the point. The kind of arrangement I would like to see would be a congressional directive to the SEC, to see to it that these problems are taken care of. I call your attention to the present very interesting situation in which Congress has directed SEC to come up with something on the extractive industries by December 1977. And the legislation which directs the SEC to do this states that SEC may use the FASB to do the technical work and SEC has announced that it's cooperating with the FASB. It will send observers to the public hearings and so on. I'll go out on a limb to say that in this particular case the FASB is going to come through with flying colors. We are going to have, by December 3 1, 1977, a set of generally accepted accounting standards for the extractive industries. Why? Because FASB knows that these things will be put into effect. SEC is under direction from the Congress to do the job. This is the kind of situation I would like to see as a continuing basis with SEC or some other designated agency. Personally, I would also like to see an overhaul of the Securities Act. It is long overdue. Those acts were enacted in the 30s -- based only upon conditions in the 20s and the (great) depression of the early 30s. This is now 45 years later. And it might be that the SEC might be phased out and some other agency created to take its place. But whatever agency is chosen to do this job, to carry out the revised securities legislation, should have explicit link with an agency in the private sector, presumably with the FASB, so that FASB understands clearly in advance what its role is. In the present situation, everything is lovey-dovey; everything is going fine except that the SEC by statute reserves to itself the right to overrule FASB. We need to drop the pretense that an agency in the private sector has the power to determine and enforce generally accepted accounting principles. FASB should act as the technical expert agency in the private sector to work with a governmental agency which has enforcing powers. The weakness of the whole procedure since the late 30s has been lack of enforcement power. Things are a little better than they used to be but we don't know how long it's going to last. It will last as long as SEC will hold up the arms of the FASB.

I'm not disturbed by the fact that we might get some legislation. I hope it is the type we're talking about which will make the lines of responsibility explicit. I am told that the Ontario securities commission has announced that it has a kind of pact with the Canadian Institute of Chartered Accountants, that will insert in its rules the findings of the Canadian committee of research. If this is true then we ought to see some early rapid progress in Canada on the establishment of accounting principles. We have been so programmed in this country to think that it is either/or that we can't see other ways of doing things. If you want to stay in the private sector, for example, you might use the stock exchange. There are some reasons why the New York Stock Exchange isn't the agency to do it. If this were in the United Kingdom perhaps the London stock exchange would be the agency, through its committee on stock lists. They could lay down the conditions, but the enforcement is there, you see, through the power to delist or refuse listing in the first place. This is another possibility that I'm laying out to you, and this is a quasi-public agency. I don't think your New York Stock Exchange is entirely in the private sector, but it lives by virtue of a set of rules developed by the SEC under the Securities Act of 1934 and subsequent amendments. And it works reasonably well, but I'm not an expert on the stock market; but what I am getting at is that I don't think that stock brokers have become government employees, who wear tattoos or anything else. I don't see that it is a necessary consequence. Obviously, the accounting profession could change; maybe it should change. It is changing whether the Congress acts in the next six months, a year or eighteen months.

Question:
I wanted to ask a question about auditing standards in the bribery situations. At this point more than 300 companies have reported to the SEC that they have discovered through audit committees of the board of directors that there have been payments of bribes in the overseas subsidiaries. Many more companies, it seems, are coming to SEC light through

investigations. They have had widespread domestic bribery, rebates, kick-backs, particularly in regulated industries such as liquor industries, milk sales and the like. Most of the accounting profession has taken the point of view that the current auditing standard of materiality does not apply because usually the amounts involved are too small to have been picked up in an ordinary audit. In view of the fact that these bribes were so widespread, it seems unlikely that the auditors were completely oblivious to the fact that these existed. Yet, we have no example on record of where management was alerted to this type of bribery by the audits that have been done in the last 15 or 20 years. What is your comment on sufficiency of auditing standards in this regard?

Answer:
Obviously, I can't speak to the extent to which the auditors were aware of these, and did not report to management what they found. But to the broad question of the responsibility of an auditor to -- lets take the case where the auditor does find -- not where he does not find -- some improper, questionable, but not illegal payments -- not in accordance with the corporate policy as announced by the board. Assume he does report to management, but says nothing in his auditor's report. This, I think, is the more intriguing question. Because, if auditors have not pursued proper steps which they should have taken we find a familiar pattern.

The rules are clear -- they should have done enough digging and accumulated enough data to support their own opinion. Therefore, the disciplinary machinery should have been brought into play. It didn't; that's all I am saying.

This doesn't raise any new issues, just because it happens to be bribes being paid through overseas subsidiaries. Let me point out that to impose an obligation to report these, not just to management which could then sit on the information and say, "O.K., we know about it, and we'll take care of it, don't worry about it," is going to change basically the auditor/client relationship. I'm not arguing -- whether this is good, bad or indifferent. It's going to change it. One of the strengths of the auditor/client relationship has been the client's belief that the auditor will not disclose information which is adverse to the client unless it effects the integrity of the financial statement. Now if these facts have to be revealed, then management is not going to reveal things to the auditors. There's going to be an adversary relationship established which is going to change the nature of the audit procedure in the field. It changes the auditor's view of what his primary responsibility is in regard to his client's financial statement. Let me give you a simple-minded example of this from my own limited experience going back to World War II. In this country we had wage stabilization in World War II. The enforcement mechanism was very ingenious. If there was a violation of wage stabilization, e.g., if there was a class of worker who was not supposed to get more than $ 1,000 per month, if in fact, he was paid more than $1,000 per month -- the full amount of the compensation paid to the worker was denied as a tax deduction of the employer, not just the override -- but the full amount. All right. On a particular audit on which I worked we discovered violations of wage stabilization. If we discovered it, we had also to assume that the revenue agents would discover it. The basic rule of chess -- never assume that your opponent is more stupid than you are -- at least as stupid as you are -- but not less. O.K., we discovered this. Our problem was not to blow the whistle, as we saw it at that time, our problem -- the question we had to raise was what does this do to the client's financial statement, assuming that the revenue agent will discover this, and disallow the deduction, and assess additional taxes? This meant that the current liabilities had to be large enough, larger than the books showed to absorb this. The focus was on the integrity of the financial statements. It was not on whether the business being conducted was honest or dishonest, under high ethical standards or low ethical standards. Also in that same audit, we had a close relationship with the management of the client to the extent that we got all kinds of data which we probably never would have otherwise. I am giving you this simpleminded illustration to show what a change this will bring about. It creates a tension between the client and the auditor that creates an adversary relationship that may make real the fear expressed about our becoming agents of the government. So, I think this has to be defined rather carefully. The logical solution is to pass laws which will punish these acts -- as illegal acts, and not expect an auditor to say or reveal it through some reporting process. Several large firms have said that they are in agreement with the new trend, and they will cooperate and see that these matters are disclosed. I think that's far enough for that particular question. I wonder about this because it illustrates what I was referring to before in more general terms -- the auditing profession is undergoing some profound changes with or without the legislation.

Question:
Is it your opinion that with the big expansion in the accounting field that today's entrants are not competent -- as compared to the entrants in your particular time?

Answer:
I don't think I said that. Could you be more specific?

Question:
Every year you hear the same thing from every teacher. By the time you get out of school and go into the accounting field -- they say, "forget everything you've learned in school because it's all changed now."

Answer:
Who says this -- who says this?

Question:
More often than not -- in my classes -- many teachers are at odds with the teaching of the text that we are giving out; and this term is no different than any other term. If we're supposed to be competent with the rules that are set up -- couldn't there be more standard guidelines for us to learn by? Because the differences of opinions between what we are learning in the text and what our teachers are teaching us, as in auditing -- its very divergent.

Answer:
All right, all right. Now we are talking about what the teacher is giving us from the lectern and what you're reading in a book? Is that what you're saying? And also in conforming with general accounting principles. Different theories that are being given out to us.

Well, I should hope that the different theories that are being given out are for the purpose of enabling you, training and educating you, to be able to handle these knotty problems when you get out. The dilemma of teaching in a rapidly changing environment is how to prepare you to answer questions five years from now, questions that we can't even formulate, that we don't even know, or give you answers to, because we don't know the questions. You've heard the catch phrase -- "decision-making under uncertainty" -- l can't think of a better illustration of "decision-making under uncertainty" than the kind of situation you're describing, the kind of thing you'll run into when you get out into the field, one, two or three years down the line. Now, how do you do that? It doesn't take much to get you to look at Commerce Clearing House Compendiums on generally accepted accounting practices or professional standards -- or the CCH and Prentice-Hall Tax Guides. How to use the index -- how to look up things? That isn't difficult -- you can be drilled on that, and you ought to learn that -- but that should take four years. But, the point is-that's not enough. Those things are telling what it's like now -- but you're not going to be answering these questions that are being raised now. You're going to be asked the questions that are going to be raised at least five years from now. By the time you are a top senior manager, or in ten years, you'll be a partner; you'll see! [laughter]

Some of my former students tell me they are asked to do some research for the partner in charge of the office. The former student asks the partner, "where do I look -- where do I start?" but the partner replies, "I don't know -- you'd better find out. "

This is the dilemma in teaching you see. In a reasonably stable society -- a static situation -- experience is a great teacher -- you simply learn what's being done and you repeat it; and you don't need to do lots of the things we do now. But when you cannot predict what the problem is -- what the question is that has to be answered -- then you have to go to a broader base -- and less detail because the details are no good. You take a text -- and it can be the best text in the world -- I know -- I've written a textbook -- but what is it? It reflects the author's experience which, the time the book is written is five, ten, fifteen years out of date. It may be perfectly good, solid -- you reference those things and find no mistakes in it, but unless it trains you to handle these situations, it is not relevant to your needs.

I've often thought that the ideal final exam -- in the advanced courses -- not in the introductory courses -- is to ask questions on points that were not explicitly discussed in the text or in the classroom. That's the only way to find out if you've learned anything and can apply it? [laughter]