

You heard a great deal yesterday concerning the state of financial presentation and disclosure. You also heard criticism of the accounting profession because of alleged failure to cope promptly and effectively with unsettled controversies and developing problems.

My remarks today are directed to another area of criticism. Independent auditors have been seriously challenged to improve their performance. Fortunately, the profession realizes it cannot ignore the challenge to its performance and credibility.

Late last year, the American Institute of Certified Public Accountants established the Commission on Auditor's Responsibilities as an independent group to study the role of the independent auditor in our society, how the responsibilities assigned to him can be more satisfactorily discharged and how the apparent gap between performance and public expectation can be narrowed.

Three of the seven members of the Commission are professional auditors who have made outstanding contributions to the profession. They are: LeRoy Layton, a former president of the Institute and chairman of the Accounting Principles Board, who recently retired as managing partner of Main Lafrentz & Co.; Kenneth W. Stringer, the senior technical partner of Haskins & Sells; and John J. van Benten, managing partner of George S. Olive & Co. A majority of the members of the Commission, although knowledgeable about the profession, are not professional auditors. Walter S. Holmes, Jr., a licensed CPA and Chairman of the Board and Chief Executive Officer of CIT Financial Corporation, brings to the Commission the perspective of top management; William C. Norby, a Chartered Financial Analyst and senior vice president of Duff, Anderson & Clark, brings to the Commission the views of an informed and articulate user; Lee J. Seidler, a CPA and professor of accounting at New York University, with experience as an auditor and business consultant, brings to the Commission the perspective of the academician. I bring to the Commission as its Chairman the background of a lawyer who has worked closely with auditors most of his adult life.

We have developed and recently published through a series of meetings and interviews with interested and knowledgeable individuals and groups, an extensive brochure,

now available from AICPA, which contains information on the scope and organization of the study and a statement of the issues to be considered. I wish again to express our appreciation to a group from FEI who visited with us. The issues relate to questions concerning the performance by the independent auditor of recognized responsibilities, whether they should be expanded to meet apparent user needs and expectations, and how the nature and limitations of the responsibilities assumed can best be communicated to all who use and rely on the work of the independent auditor.

I wish now to take a minute or two to tell you how the Commission operates and what it is planning. We have been meeting for two or three days each month since November 1974. We generally meet in New York City, but we have met twice in Washington to develop a close liaison with government agencies concerned with auditing. We have met with a number of concerned, well-informed individuals who have given us their views on the study and the manner in which it should be conducted. These individuals were selected from virtually all groups in our society with significant interest in the auditing function. We have also met with members of the Canadian financial and legal communities and have had assistance from the Canadian Institute of Chartered Accountants. The development of background information, surveys of existing literature and other research work, have been completed on several of the topics within Phase 1 of the study. A series of research projects have been commissioned. Certain individuals have been invited to submit papers on specific topics.

We have decided that studying the specific issues in three phases will facilitate the gathering of evidence and the views of interested parties. In the first phase we have been considering issues that pertain primarily to a clarification of the independent auditor's present responsibilities; in the second phase, we will consider issues concerning extension of the auditor's role; and, in the third, we will consider issues that relate to the institutional framework of the audit function and possible changes in that framework.

I should emphasize that the resolution of the specific issues will inevitably depend on some basic value judgments about two general issues which seem to us fundamental to the

overall study: (1) the role of the independent auditor in society, and (2) the gap between performance and reasonable expectations.

Obviously, our views on the first -- role of the auditor -- can only emerge after all of the specific issues have been considered.

The second general issue -- the gap between the performance of the independent auditor and the needs and expectations of those who use and rely on the auditor's work -- necessarily requires an evaluation of the differences between the attained level of performance of the independent auditor and the level of performance expected by users. We must consider the extent to which the gap is caused by substandard performance of present responsibilities, by users' reasonable demands that auditors accept additional responsibilities, and by users' misunderstandings or unreasonable expectations of the audit function.

I do not plan to explore with you today all of the specific issues identified. I will note, however, the six issues to which we have directed primary attention in the first phase of our work.

1. The auditor's opinion on financial presentations -- the meaning of "present fairly. . .in conformity with generally accepted accounting principles."
2. His responsibility for the detection of fraud.
3. Reporting on uncertainties.
4. Detection and disclosure of adverse management behavior.
5. Improved communication to users in the auditor's standard report as to the responsibilities assumed and the limitations inherent in the auditor's work and report.
6. Improving auditing standards, methods and techniques.

We are well along in our discussions of some of these issues. We realize that questions concerning the role of the independent auditor associated with annual financial statements are broader than the specific issues that we have been considering in this phase of the study. The

nature and dimensions of the second and third phases of our study can be gained from the published statement of the issues, to which I respectfully direct your attention.

I should now like to speak briefly to certain of these matters from the vantage of a practising lawyer, albeit one whose recent experience has, in the main, been as counsel for an accused auditor.

In a private action for damages against a major accounting firm, the United States District Court for the Southern District of New York recently ruled that the inquiry was

“properly focused not on whether [the independent auditor’s] report satisfies esoteric accounting norms, comprehensible only to the initiate, but whether the report fairly presents the true financial position of [the issuer], as of November 30, 1969, to the untutored eye of an ordinary investor.”

Some of you may be familiar with this pronouncement in the Herzfeld case, that an independent auditor’s liability should be based on “truth” as judged by a lay jury rather than by a jury of fellow professionals.

However, this one judicial characterization of the standard by which an independent auditor may be held liable to the users of financial statements is by no means an isolated example. On the contrary, it probably typifies the views of people by whom his work is -- in a particularly literal and meaningful sense -- now being judged. The courts are now saying that the accounting profession (and, incidentally, various other professions including my own) will no longer have the ultimate right to establish its own standards and to judge the performance of its own members. On the contrary, although the profession’s definition of its own objectives and standards of performance will continue to be important, the responsibilities of the auditor will henceforth be based, at least in part, on the expectations of the people who directly or indirectly use his work.

This shift in the ultimate basis for determining liability has made it more essential than ever that the accounting profession do its utmost to narrow the gap between the

performance of its members and the expectations of users of its work. This gap has three parts, and the profession can do something about all of them.

Part of the gap between the expectations of users and the performance of auditors is traceable to erroneous or exaggerated expectations. This part the accounting profession can reduce by better presentation of its own case, by better communication of the limitations of the science (or is it art?) of accounting and the science of auditing, and by better expression of the significance of the audit.

Another part of the gap may be a failure on the part of auditors to set sufficiently high standards for themselves. For example, while I have some problems with the view of the judge I quoted earlier, it may well be that the independent auditor has sometimes paid too much attention to whether particular items in financial statements conform with specific rules and not enough attention to whether the financial statements as a whole tell the issuer's story fairly. If that is a problem, it may be because the profession has not satisfactorily defined the relationship between its technical rules and operating procedures on the one hand and its end product on the other.

A third part of the gap between users' expectations and auditors' performance relates, of course, to isolated, but nevertheless too frequent, instances of substandard performance. Among the reasons frequently cited for inadequate performance are insufficient training or experience of particular auditors, inadequate quality control, time pressures, client pressures and competitive pressures within an accounting firm and among firms.

The Commission on Auditors' Responsibilities is now working to understand and, where possible, to narrow all three parts of this gap between expectations and performance. Let me give you some examples of the specific subjects we are thinking about and how they relate to this gap. First, we are concerned that users of financial statements and the public, including some judges, do not adequately understand what an auditor's report on financial statements represents. We hope our report itself will be of help, by being readable and persuasive. On a more specific level, as I have already noted, we are considering the text of the auditor's report to

determine whether and how it might better express the nature of, and limitations on, the auditor's undertaking.

To take a second example, we are concerned that neither the public nor the profession has an adequate understanding of the role of auditing standards and accounting principles. We are therefore wrestling with the extremely difficult problem of interpreting (and perhaps ultimately recommending changes in) the standard language of the auditor's report about fair presentation in conformity with generally accepted accounting principles. Apparently, this language is obscure to many, even users who are sophisticated by any reasonable standard, with the result that the responsibility assumed by the auditor is not adequately understood.

The Commission will also consider the exposure of auditors to liability. The concern here is not limited to the three members of our Commission who are or have been senior partners of accounting firms. There are, in my view, instances in which liability is appropriate. Whether or not there is wide agreement with this view, it is probably that private damage suits against auditors are here to stay. Yet, it may not be unreasonable to suggest that damages be limited to those cases where there has been genuinely substandard performance by the auditor involved. On this premise, the auditor should not be exposed to damage suits arising entirely out of a misunderstanding between him and the public as to what is expected of him. The logic of the situation seems deceptively simple. Since there is little chance of prohibiting the lawsuits, we should eliminate the misunderstandings. Developing criteria of performance and legal procedures that will hold the auditing profession to high standards, but will provide for judging the individual or firm only by those standards, is an urgent task on which the Commission will attempt to assist the auditing profession and the user audience it serves.

Another concern is that, as our society and its economic activities become increasingly complex, users expect the auditor to keep pace, but the auditor may not always be trained and equipped to do so. Therefore, although we do not intend to make any general study of the adequacy of specific auditing techniques, we do hope to examine the profession's response

to new methods of doing business and new ways of recording and reporting the events that constitute business operations.

Finally, let me illustrate how these various concerns relate in the context of a specific problem of current concern: the detection of fraud. That there is a gap between some people's expectations and some auditors' performance in this area is clear. I suspect, and there is evidence to support my suspicion, that the average corporate shareholder believes the auditor's report offers him specific assurance that there has been no material management fraud. But, as you all know, SAS #1 contends (I use that word deliberately) that the auditor's examination cannot be relied upon to detect fraud. The contrast between the perceptions of the auditor and those of many users reminds one of a mythological beast invented by Woody Allen that was half woman and half swan -- unfortunately divided lengthwise. The situation is downright dangerous to the profession. If the auditor is to escape becoming an insurer of the absence of fraud, he had better define his responsibility in a way he can live with, and the public will understand and accept, and he had better arm himself with the techniques necessary to discharge the responsibility thus defined.

Clarifying the auditor's responsibility for the detection of fraud is an issue on which we have made considerable progress in our deliberations. We have concluded that the nature and limitations of the auditor's responsibility for the detection of fraud is unclear both to auditors and users of financial statements, and that the ambiguity and negative language published in professional standards make clarification of the auditor's responsibility essential. Our tentative conclusion, at this stage of our study, is that the only way independent auditors can begin to cope with the expectations of users in this area is by acceptance of a canon that the detection of fraud, as we would define it, is an important objective of an audit.

Recognizing the detection of fraud as an important objective of an audit does not mean that an auditor should be responsible for the detection of all frauds or that he should be held liable to investors for all undetected frauds. We believe, however, that a proper recognition of the objective will provide the perspective for a reasonable delineation of the auditor's

responsibility. A description of what the auditor's responsibility should be may require development of a standard that describes the level of skill and care an auditor should exercise in searching for fraud. At the moment, it appears that this is the most reasonable of the several possible approaches which we have considered. A possible description of that responsibility might go something like this:

An independent auditor in an examination of financial statements has a duty to make a diligent search for fraud and is responsible for the discovery of those frauds that the exercise of due audit care would normally uncover.

Such a statement would require a careful specification of the elements of due audit care as they relate to the detection of fraud.

We recognize, of course, that such a standard will not and should not provide the auditor immunity from litigation; but it can serve as a guide by which certain claims should be tested and by which litigation can be terminated in a reasonable and equitable manner. This is not to suggest that such a statement of the auditor's responsibility would be absolute. The development of the standard would deal with two important underlying premises. First is the recognition that no profession is expected to achieve absolute perfection in its performance. A professional undertakes to act in good faith, and with integrity and due care, but not for infallibility. The auditor should recognize a duty to search for fraud; he should not be expected to succeed in uncovering all frauds.

Second, such a statement should recognize that an audit is a practical operation performed in a commercial setting considerably influenced by the economic factors that affect the day-to-day operations of practical businessmen. The auditor does not function in a Utopian Environment in which all men are ethical or equally competent. His success in discovering fraud is limited by the practical conditions under which he works and the practical purposes that he serves. Such a statement of responsibility would be consistent with the limitations imposed on

auditors by cost/benefit considerations. The auditor cannot expand his examination procedures beyond the point at which the cost exceeds the possible benefits.

Our deliberations on the fraud issue indicate how intensive our consideration will be of many of the other issues we have identified. We have made progress on most of the other issues included in Phase I of the study. We plan to continue our deliberations until we have reached, hopefully, a consensus on each of the issues. A great deal remains to be done.

We plan to conduct one or more public hearings in the Spring of 1976 at which all individuals and groups interested in or concerned with the work of independent auditors will be afforded an opportunity to present their views. Before scheduling public hearings, we plan to distribute one or more discussion documents and a notice of hearing with a call for position papers. We hope to complete the discussion documents and set the dates for public hearings later this fall or early winter. After the completion of hearings, we will complete our deliberations and prepare a final report.

We believe that, at the conclusion of our study, we will be in a position to recommend actions to assure that independent auditors discharge their responsibilities in a manner that is responsive to the needs and reasonable expectations of society. We recognize that vigorous response to the challenges confronting the auditing profession is necessary. There are no easy answers and no convenient scapegoats. The credibility of the auditing profession is at stake. Our goal is to recommend actions designed to redeem that credibility.