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"WHAT IS EXPECTED OF THE INDEPENDENT AUDITOR:  
FROM THE VIEWPOINT OF THE INVESTOR"

ADDRESS

of

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**"WHAT IS EXPECTED OF THE INDEPENDENT AUDITOR:  
FROM THE VIEWPOINT OF THE INVESTOR"**

Mr. Haskell has just pointed out, most ably and clearly, some of the things which he believes the investor is entitled to expect of the auditor. I have been asked to discuss the same question emphasizing the role assigned to the independent auditor by the philosophy underlying the Securities Act of 1933, the Securities Exchange Act of 1934, and the requirements that have been promulgated under them by the Securities and Exchange Commission. Both of these acts were designed to afford additional and more accurate information, and therefore protection, to that portion of the investing public who purchase or sell securities over a national exchange, or purchase securities in response to a public offering in interstate commerce. Eventually, of course, the securities of most large and medium sized companies will be subject to one or the other of these statutes. By statutory mandate it is thus the duty of the Commission in each problem it faces to keep in mind not only "What does the public investor receive", but also "What is the public investor entitled to expect". Fortunately, the Congress has invested the Commission with regulatory and rule making powers designed to ensure that the answers to these two questions shall not be unreasonably different.

Before examining the question before us, point by point, I would like to quote briefly from some of the past rules of the Commission relative to auditors and auditors' responsibilities.

In April, 1934, the Federal Trade Commission adopted a rule requiring a concluding paragraph in each accountant's certificate, in substantially the following form:

"Subject to the foregoing comments, we have, after reasonable investigation, reasonable grounds to believe, and do believe, at the date of this certificate, that the statements contained in the attached balance sheets and in the attached profit and loss statements truly and fairly reflect the application of accepted accounting practices to the facts disclosed by our investigation, and that there is no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

This rule now supplanted by Rule 651 represented an adaptation of the statutory language of Section 11 (b) (3) of the Securities Act relating to the liability of experts whose names are mentioned as having prepared or certified any part of the registration statement. That section you will recall imposes civil liabilities for misstatements and omissions unless, (I am quoting now) "as regards any part of the registration statement purporting to be made upon his authority as an expert ... (i) he had, after reasonable investigation, reasonable grounds to believe and did believe at the time such part of the registration statement became effective that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . ." And a later section, referring to this paragraph, reads "In determining what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property." As in many

discussions of complex matters, so in discussing problems of accounting and auditing under the Securities Act, it is often easy to lose sight of these "first principles". This standard of performance for experts is embodied in the statute itself.

So far, little attempt has been made to prescribe the scope of examination that is prerequisite to certifying financial statements under the Securities Act and the Exchange Act. Instead we have followed the alternative of relying upon the standards of procedure announced by the accounting profession, and the general sanctions embodied in the Acts or in the common law. As you know, the present rule 651 and the forms only require an "opinion of the accountant or accountants in respect of the financial statements of, and the accounting procedures followed by, the person or persons whose statements are furnished." Affirmatively, the rules say nothing as to what the auditor must do. Negatively, they say that nothing in the rules "shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of a regular annual audit." In the proposed but not yet adopted Regulation S-X this language has been re-drafted so as to prohibit the omission of any procedure "which independent accountants would ordinarily employ in the course of an audit made for the purpose of presenting comprehensive and dependable financial statements."

In addition to these substantive requirements and certain procedural matters, the present rules ask that the accountants' certificate shall be reasonably comprehensive as to the scope of the audit made. This requirement was added in March, 1935 but in operation has not brought the information expected, as was very clearly pointed out by Judge Healy in a recent speech before the Midwestern Conference of the Controllers Institute of America.

In contrast to the time we have spent on accounting principles, there have been few cases before us involving the question of whether a reasonable audit was made. This is perhaps due to lack of information, in the normal case, as to the audit procedure followed. The cases that do appear come to us after the horse has been spirited from the barn -- as in the Monroe Loan, Interstate Hosiery and McKesson cases. The situation prompts the inquiry as to whether disclosure of audit procedures followed in each case would not result in as many problems as does the requirement of disclosure of the accounting principles followed in the preparation of the statements.

In any consideration of the general question of accountants' certificates and audit procedure, there always arises the question that has been aptly labelled "Whose statements are they?" Recent articles and discussions culminating in the round-table led by Mr. Steyer have indicated that some accountants take the position that a certified financial statement is a representation of the company upon which the accountant has expressed his opinion. Others feel that since the accountant often physically prepares the statement it is his representation, particularly if, in order to get out the statement, he has had to do a good deal of the work of preparing and entering normal adjustments, and in some unusual cases, of preparing the books of original entry. Quite obviously the financial statements reflect the business of the company, not that of the certifying accountant. Quite obviously, also, an accountant can and sometimes does prepare statements for a business that represent principally his own judgment, not that of the management. The statements reflecting the results of an investigation

by an accountant engaged by a creditor or prospective purchaser are the usual examples. On the other hand, the statement presented by management to a creditor, stockholder or prospective investor are obviously a representation of that management, whether prepared solely by them, or in conjunction with outside accountants. It is likewise true that an accountant as to many matters and to varying degrees may quite properly rely, in the ordinary case, on representations made by the management about the business. However, ascribing to management the primary responsibility for the statements or insisting that the accountant merely expresses an opinion as to the management's representations does not in my view of the matter lessen by one whit the accountant's responsibility for the accuracy and sufficiency of the statements. In a normal audit, should the accountant fail to take proper measures to subject the representations of the management to his expert scrutiny and investigation, he is in my opinion derelict in his duties, and as responsible as if the representations were solely his own.

The relation of the certificate and the scope of the audit to this theory of "whose statements are they" has, I think, three important consequences. The first is that the statements themselves may not be self-contradictory within their four corners. The second is that the accountant must be considered to have approved all that is contained in the statements and footnotes, unless specific exception thereto is made in his certificate or report. The third is that any permissible exceptions or limitations must be found in the accountant's certificate, although some data may and sometimes should be included also in the statements as a matter of information or emphasis.

With this general introduction, I turn to the basic question, "What is the public investor reasonably entitled to expect of the auditor?" It is not a discredit to auditors to say that they are neither automatons nor omniscient. Procedures, however excellent in themselves, must be expected to vary in utility and reliability with the training, ability, experience, alertness, and personal characteristics of the persons to whom they are entrusted. Likewise, the facts disclosed by the procedures chosen are often dependent for significance upon the auditor's acumen and his memory of other particular facts. However, neither of these inherent limitations to auditing can serve as an excuse or cloak for inadequate and lax methods, or for inexperienced and unintelligent work. As one of you, Samuel J. Broad, recently said "The accountant who signs a report holds himself out as being skilled in accounting and auditing procedures and as being qualified to render the report and to express an informed opinion on the accounts; second, he holds himself out as having made the type of an examination which a qualified accountant would make in the circumstances before expressing his opinion".

Under the Securities Act and the Exchange Act (and I believe in general) there are several positive implications which the public investor is entitled to draw from the certificate of an independent public or independent certified public accountant. They are these:

1. That the work has been done by independent experts.
2. That an audit of the business has been made.
3. That the examination and its results are such as to enable the auditor to express an informed opinion and that his opinion is stated as clearly and fairly as possible.

Many state laws have recognized the necessity of entrance requirements to the profession of public accountancy. These involve ordinarily a stipulated amount of general and specialized education plus a minimum period of practical experience. It is not always true, however, that these same requirements are applicable by law to all who are engaged in accounting and auditing work on a particular engagement. Division of work upon a large engagement is without doubt a necessity. But at the same time it places a special and heavy responsibility upon the accountant who is to be responsible for the work done by virtue of having attached his signature or that of his firm to the certificate.

In the first place it seems clear that some duties cannot consistently be delegated. Broadly speaking, an audit is a procedure by which information is brought to light and subjected to the expert analysis of an experienced accountant. It is often urged that an adequate procedure of turning up information is in large part peculiar to the particular case, its adequacy depending mostly upon the discernment and experience of the person designing or adapting standard methods to the particular case. Therefore, while the details of the work of gathering the necessary information may be delegated to others, the design of the program should be approved by the person who will ultimately sign the certificate only after his judicious scrutiny of the special circumstances. Expert analysis of what is to be done seems to me an inescapable obligation of the person whose name is to be used if the ultimate results are in any real sense to be considered attributable to, or judged by, that person as one whose profession gives authority to a statement made by him.

In the second place, if work is to be delegated, it is incumbent upon the principal to see to it that a procedure is in effect which assures that the work given to a particular subordinate is commensurate in difficulty and importance to the ability and experience of that particular person. To start with, it must be remembered that even the simplest audit procedure may be of no value unless carried out with alertness and inquisitiveness as well as care and familiarity. Beyond this, the special needs of a particular assignment must be met.

But the duties consequent upon delegation of work do not end with the selection and assignment of personnel. There remains the necessity of adequate review and supervision. I do not believe this can be satisfied merely by reviewing the results produced any more than can the adequacy of a system of internal check and control be determined solely from an examination of the instructions on the one hand and the journals and ledgers on the other. Ample observation and contact with the raw data by those having a broad viewpoint and greater authority seems essential to ensure that the delegated work is being carried out satisfactorily. In turn, therefore, those who are charged with immediate supervision of the work must be equal in their greater ability and broader experience to the exacting tasks of overseeing the details and subjecting the results to their more experienced judgment.

In this process of supervision there remains to be considered the final review to be made by the principal ultimately responsible for the work. Here perhaps is the point at which accountancy most exhibits the characteristics of a profession, since it is here that the opinion of the principal, as an expert, is finally formulated. Ideally, he has already

exercised his professional judgment as to what should be done and has seen to it that the work was entrusted to capable subordinates and was satisfactorily carried out by them. He is now in a position to examine the significant information disclosed by the audit and to render thereon his informed opinion. Unfortunately, in a number of cases the review has failed to meet these standards in one or more respects. In one of them, the Interstate Hosiery case, the Commission discussed this matter of supervision and expressed its conviction that the final review should be more than a series of perfunctory questions, that it should be designed to attain at least these principal objectives: first, the integration of the original work papers with the financial statements and second, a searching analysis of the ultimate facts developed in the course of the actual audit.\*

A summary of this point, "that there must be experts", is the simple statement that accounting is a profession. As such, it engenders responsibilities for the type of service to be performed. That responsibility has been aptly expressed by Professor Kester in an article in the Accounting Review last September.

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\* See Sec. Exch. Act Release #2048 dated March 22, 1939, p. 7-8 which reads:

"We think it is self-evident that the review upon which an accounting firm assumes responsibility for work done by subordinates must be more than a series of perfunctory questions as to the performance of particular items in an audit program. Nor should explanations of unusual items be accepted by a reviewer without support in detail from the working papers. As a matter of principle, a review should, it seems to us, be designed with two objectives in mind: first, to insure the integration of the original work papers with the financial statements; second, a searching analysis of the ultimate facts developed in the course of the actual audit. An adequate review with the first purpose in mind should serve not only to disclose intentional or accidental misstatements but should also serve as a method of internal check and control on the work of the firm's subordinates. This branch of the review, it seems to us, need not necessarily be carried out by a partner but should at least be done by one well versed in the procedures adopted by the firm and in the general principles and terminology of auditing and accounting. If not a partner of the firm, such review should, in our opinion, be made by persons who are independent of those actually performing or supervising the audit work as well as of those who prepared the draft of the financial statements. The second branch of the review is designed to enable the accounting firm to interpret intelligently the figures it has obtained and to which it is to certify. This part of the review should, it seems to us, be made by a person, preferably a partner, qualified by his knowledge of sound accounting principles and his familiarity with the accounting phases of the industry and the more important problems of the particular company. In this manner the facts ascertained by competent employees can be subjected to the independent and broader judgment of a more experienced person who can by searching inquiry of the supervisor or senior and by examination of significant items in the work papers and schedules reach an informed judgment both as to the adequacy of the audit work done and as to the integrity and clarity of the financial statements themselves. We are satisfied that a review along these lines would have exposed the irregularities in this case."

"In connection with professional accounting service, there is implicit a contractual obligation to render a good type of service and this obligation extends not only to himself but to the members of his staff. The so-called common law rule of caveat emptor, "let the buyer-beware", hardly applies in the same degree or to the same extent in the contract between client and professional man as in contracts covering the exchange of goods. In connection with the contract of professional service, there is always a guarantee. It is largely out of this well-recognized responsibility to render proper service that the profession has had to take cognizance of the necessity for education. If a professional man is to be held accountable not only for the type of service which he himself renders, but also for that rendered by his staff, common sense and business prudence demand that his staff be selected with care."

To this concept of what is meant by "auditors" the Federal Securities Laws have added the concept of independence. As opposed to subservience there is no question that it is essential. To define it in the abstract is not difficult -- it is simply that the auditors must be completely objective, free from bias, and devoid of any entangling affiliation. To apply it in individual cases is often difficult. Obviously, there are circumstances where the chances of objectivity are greatly lessened. Without discussing the point in detail, I should like to point out that, among others, the relationships of officer, director, employee, and partner have been placed in this category by rule of the Commission.

The second point I have listed is that an audit of the business has been made. Samuel Broad recently stated in the hearings regarding McKesson and Robbins that "the primary purpose of an accountant's examination for a company which issues financial statements is to satisfy himself that the financial position and earnings are fairly stated". This view was affirmed by the other witnesses called to the stand. Obviously there is implicit in any such view the assumption that the auditor has satisfied himself by appropriate means that there is a business of approximately the character which the statements being certified purport to reflect. At a great many points in the audit varying degrees of knowledge about the business being conducted are essential to an intelligent review of the statements and accounts. It is perhaps unnecessary to emphasize the importance which economic and business facts have in allocating costs and profits to particular periods. All of these and, in addition, the administrative organization and personnel have direct bearing on the system of internal check and control and the extent to which reliance thereon is justified. The examination of certifying accountants, although in the main concerned with financial records, cannot be confined to them.

It seems to me that the examination which an investor is entitled to expect of certifying accountants must be such as will reasonably establish, by adequate means, the authenticity of the transactions and the accuracy of the records of those transactions. This must be done by tests to check the results shown by the records against each other, against physical facts, against the records of subsidiaries and affiliates and against information obtained from unaffiliated persons with whom the company does business. It has been urged that adequate reconciliation of cash on hand and bank balances is sufficient to establish authenticity of all accounts, because of

the key position which bank transactions play in normal business life. Disregarding the possibilities of manipulating or falsifying such transactions and of short circuits in which cash is not involved, it would seem that this is a slender base upon which to rest the authenticity of the entire accounts and statements. In contrast, many have urged that knowledge of the business should be obtained to a considerable degree by first-hand observation, and it is common practice for accountants to employ procedures which involve activity by independent third parties. It is perhaps true that the attention which events have directed toward standardizing accounting principles has resulted in less attention to audit problems. It is as a corrective to this possibility that the recent resolutions of your Institute and the discussions about them have to my mind lasting significance.

It may be worth pausing a moment at this point to consider the bearing which the present resolutions have on this topic. I would like first to consider the importance to be attached to the system of internal check and control. As companies expand, it is hardly necessary to say that their transactions and records become so voluminous as to preclude an examination of all transactions. Perforce, the company must establish a routine and the auditor under normal conditions must rely upon it. To justify reliance it is implicit that the auditor thoroughly inspect the system; first, to see whether in principle it should produce reliable results, second, to see whether it is operating as it was set up to operate, and third, to see whether it is, in fact, producing accurate and reliable results, this latter by tests of the records against themselves, against the documents which are the grist of the mill, and against physical facts and independent sources. Only to the extent these tests give positive results is the auditor justified in relying on a sampling process as the basis for an informed opinion.

With this in mind I may turn to physical test-checking and supervision of inventory taking. There seems to be little doubt that such procedures are possible. There may be some doubt as to the feasibility of immediately putting such measures into universal practice, but much can be hoped for from the wider use of the natural business year and the performance of the work at other than the closing date. Here however I would like to consider principally the value of such test-checks or supervision as regular instruments of audit procedure. That both supervision and test-checking have very important limitations cannot be denied. In any case, the limitations of a sampling process are present. In many cases identification presents difficulties, yet even here it may be noted that bare correspondence with the records in quantity and general description is significant particularly when tied in to an examination of the company's shipping, storing and receiving habits. With their limitations in mind, of what importance are such procedures? Obviously, the correctness of the amount at which inventory is carried is not thus directly or independently established, since in part at least that will depend on the cost records maintained. In addition, there are the difficulties of condition, obsolescence, salability and identity. Nor do these procedures conclusively establish quantities or ownership. On the other hand if these procedures be considered as means of checking the system of internal control as between the paper results and the physical facts, such tests have, I believe, great utility, for they are not being made in a vacuum, but in the light of the auditor's general knowledge of the business, its financial records, and its business procedures. If the samples taken agree with the results of the physical inventory, this points heavily toward the latter's correctness and to the adequacy of the company's methods. If they confirm the



company's records of a perpetual inventory, or of sales and purchases, this lends authority to the conclusion that the internal accounting system is producing reliable results. Such procedures broaden considerably the base upon which the final accounts are erected.

These are examples of the methods by which the auditor has proceeded with his examination. The next point to be considered is how extensive an audit should be made. In this sense of the word, the term audit may I think be taken by the investor to imply an examination of the records of the affairs of the company sufficient in scope to justify the certifying accountant in expressing an opinion as to financial statements on which investors are to be invited to rely.

It may be of interest in this connection to note a section of the recently enacted Barclay Bill. That bill seeks to subject to definite standards the indentures and agreements underlying bond issues sold in interstate commerce. Among other things, it provides a mechanism through which the trustee will be able to satisfy himself that the company is in fact acting in accordance with the provisions of the indenture. One requirement is the submission of certificates or opinions by experts. Such opinions may be given by properly qualified expert accountants with respect to certain matters that are subject to verification by accountants. In the case of any expert, Section 314 prescribes to some extent the nature of the certificate required by the following language:

"(e) Each certificate or opinion shall include (1) a statement that the person making such certificate or opinion has read such covenant or condition; (2) a brief statement as to the nature and scope of the examination or investigation upon which the statements or opinions contained in such certificate or opinion are based; (3) a statement that, in the opinion of such person, he has made such examination or investigation as is necessary to enable him to express an informed opinion as to whether or not such covenant or condition has been complied with; and (4) a statement as to whether or not, in the opinion of such person, such condition or covenant has been complied with."

Returning now to the question of financial statements for investors it is not necessary at this point to attempt to outline what would constitute an examination sufficient to satisfy a particular auditor. It is enough to point out that in my opinion it is necessary that his examination be at least as extensive as a representative group of accountants would consider necessary under the circumstances. To some, it may seem onerous that an expert's opinions should thus be subject to the views of others. However, standards of performance that are not subject to exact measurement and description but are nevertheless subject to review are a part of every day life. The same advantages and difficulties are present, for example, in the vague but compelling concepts of reasonable care, materiality and many other established norms. Certainly, if the public investor is to be asked to look upon the certifying accountant as an expert, he is entitled to believe that the accountant has acted as an expert would be expected to act.

In this section also there is the question of what the investor expects the auditor to have done to ensure a fair presentation from the value standpoint. This topic is perhaps closer to accounting than auditing and may here be dismissed rather briefly. It seems to me the investor may reasonably

expect that the auditor has satisfied himself that the bases of valuation employed are in accordance with generally accepted accounting conventions, in principle, and, if the convention involves an estimate, as in the recognition of declines in value or of unrealized losses, the provision made has reasonable justification and is adequate and fair, in the auditor's judgment based on his special knowledge and experience.

The final implication which I have mentioned is that the examination and its results are such as to enable the auditor to express his opinion. To some extent this overlaps with the preceding point, but I would like to deal with it separately and in broader terms.

These cases fall into three convenient groups. At one extreme, there is the group of cases in which the examination or its results are such that no certificate can be given. If the examination has been circumscribed by the terms of the engagement, or in its performance by the accountant, to such a point that there is no adequate basis for judgment, then certainly no certificate is possible. At times, this policy will be difficult to follow. There will have to be drawn in the mind's eye a line between those cases in which exception and disclosure, based on the scope of the audit, will suffice and those cases in which no certificate should be given.

Occasionally, there will be cases in which fraud has rendered the records so unreliable as to be extremely dangerous, if not useless, as a basis for forming an opinion. Such cases are often not far removed from cases in which no certificate should be given because of the incompleteness of the records, the absence of supporting documents and the like. These are not cases in which the records are merely poor, but cases in which there are neither regular accounting records nor sufficient original documents. Perhaps the case falls within the language of the Bankruptcy Act which prohibits a discharge to a person who has failed to keep or preserve books of account or record from which his financial position and business transactions can be determined unless that condition is justified under all the circumstances of the case.

As another example, there is the case in which the exceptions which the accountant is forced to take to the accounting principles and procedures reflected in the statements are so extensive or deep-seated that to render an opinion, subject to such exceptions, would be meaningless. This point of view you will recall was expressed by Stanley Fitch in the April issue of *The Certified Public Accountant* and reiterated in the recent resolutions. Under the two Securities Acts, of course, exceptions in any case are acceptable only if the problem is controversial and there is more than one widely accepted view.

It need not be implied that the accountant should give no written statements of his opinion in these cases. On the contrary, if he has been engaged to make a report there are certainly circumstances under which mere withdrawal from the engagement would be unfair -- as when he has been engaged by the stockholders of a publicly-held company. In such a case I have seen a report which read "It is not possible, therefore, at this time to present final balance sheets that fairly reflect the financial position of the companies." In general, a brief signed report that the firm is unable to express any opinion as to the accompanying statements, citing the reasons, would seem to be a reasonable solution. Perhaps it should also refer to an accompanying and detailed statement of the accountant's observations as to particular matters.

The second group, at the other extreme, of course, is the examination which leads to the present short form of certificate or report with all which that implies. The difficult cases are in the third group -- those which fall in between -- and it is here, perhaps, that the independence of the certifying accountant, a thing required by the Securities Act and the Exchange Act, is of great importance. To my mind, one essential of the certificate in these cases is that the precise nature of the accountant's exception be clearly and unequivocally stated. This means first that permissible limitations as to the scope of the audit, exceptions based thereon, exceptions taken as to accounting principles and procedures followed, and exceptions based on the need for consistency should each be separately earmarked as a class, and within each class the nature of the exception and the basis therefor specifically pointed out. In most cases it is almost a necessity to indicate the alternative which the accountants would choose and, in order to point up the significance of the exception, to disclose wherever possible the effect of applying the accountant's choice. Finally, the certificate or report should contain space for the disclosure of unusual and significant features of the audit. If, to take an extreme as an example, the accountants in a first audit have found no accounting records and have had themselves, or have had to have others, write up from original documents accounting records of the transactions for the whole or a substantial part of the period, this fact should to my mind be disclosed, for is it not true that a great part of the reliance placed upon accounting records is based on the fact that the analysis and entry were made in the regular course of business at or about the time of the original transactions, when the events to be recorded were still fresh and presumably known in detail?

These, I believe, are the things which a member of the profession of accountancy should hold out to the public and are the things which are properly to be expected of the independent accountant and auditor. If some of them seem novel or too much a counsel of perfection, I would cite you this statement:

"If it should be thought that the standard I have throughout advocated is somewhat Utopian in character and unattainable in practice, I can only reply that I maintain that, to me, an incomplete investigation seems worse than useless; and I am convinced that it is only by voluntarily accepting, and even increasing, the responsibilities of our position that we can hope to maintain and to increase the large measure of public confidence we at present enjoy."

". . . it is well to remember that, however desirable it may be to know exactly the bare extent of the legal responsibility, the real professional responsibility to clients ought always to be the ideal; and further, an auditor will be the worst of friends to his profession if he studiously exerts himself to narrow the responsibilities and so to dwarf the importance of his position."

That statement was made by L. R. Dicksee in 1892 in a book entitled "A Practical Manual for Auditors".