

THE CASE FOR CONTINUATION OF MANDATORY INDEPENDENT AUDITS FOR
PUBLICLY HELD COMPANIES

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When I was asked to speak on this topic I will have to admit that I did not initially view it as a hot one. Nevertheless, it did seem desirable to look once again at the somewhat strange phenomenon called an audit by an independent public accountant to see whether or not the conventional wisdom which asserts its necessity is justified.

The first question to be considered is whether or not, in fact, we want totally independent audits. Here I think the answer is probably no. Independence does not necessarily lead to assurance and ultimate independence which would require elimination of all dependence on communication with clients would be bad news indeed. The ultimate independent audit would be one where the auditor arrives on the scene, is handed the financial statements and the books, and talks with no one within the company. I think we could agree that such an audit would very likely be a rather bad one since an audit depends on candid communication between auditor and client in order for the auditor to develop the necessary thorough knowledge of the company and its business which he must combine with a knowledge of the accounting measurement model.

What we do want, therefore, instead of absolute independence is a dispassionate unbiased professional review of financial statements. In addition, we expect auditors to be proficient in the measurement and communication of financial information, and to assist their client as necessary to insure adequate reporting to the public.

As indicated above, an audit is a rather strange creature and not at all the way in which it is perceived by most outsiders. In an overwhelming majority of cases, the audit is essentially a cooperative effort because the interests of management, the auditor, and the public coincide. In these engagements the auditor has as his principal responsibility a review of the adequacy of financial information systems of the firms with emphasis on the needs of the outside investor. In this review, the auditor should also be aware of the information needs of management and, as necessary, make appropriate recommendations to improve management's control of operations.

The auditor's role then is twofold- -attestation and consultation. The auditor uses his professional skills and absence of bias to bear public witness to the reliability of financial information included in an annual report to shareholders and to work with management to improve the usefulness of the financial information system for both external and internal reporting purposes.

It is worth noting that in a cooperative audit engagement even a bad audit does not have a very high social cost because when the financial statements prepared by the client do present fairly the results of operations, an audit deficiency will not result in misleading data being given to the public. It may be that total stockholder information is a little less good than it could be and that the audit fee is largely wasted, but these are not the major costs that exist where deficient audits are combined with managements who are trying to obscure the reality of their operation.

While an audit is normally a cooperative effort, perhaps 5% of the time adversary conditions arise. These are situations in which the interests of management and the public are diverse, where there are benefits to management from a process of reporting other than the full and fair results of operations. These are the tough audits, where the auditor more than earns his fee and has trouble collecting it. In these circumstances the auditor has the principal role of arbitration between the interests of management and the public, and in such cases he must always remember that he serves the public first. He must avoid the situation in which the public perceives it has been cheated by deficient financial reporting because abuses of this sort carry a very high cost.

After considering the nature of the audit, we must next test its economic utility. In this connection the costs of audits of public companies in the United States are not difficult to measure. It has been estimated to be between \$750 million and a billion dollars per annum. This is not a small figure and the question that must be answered is whether the value to society justifies the cost.

The benefits from audit services, however, are harder to quantify. As a starting point there are the benefits of improved financial information systems which result from the auditor's review and suggestions. For most companies the auditor also contributes to improved external financial reporting procedures and results; presumably he improves the communication process between management and investors. Finally, the auditor contributes significantly to the avoidance of abuse and, as previously indicated, the cost of abuse is very high. This service helps keep the company out of trouble, protects the Board of Directors, and builds the confidence of investors.

Confidence is a key to good markets. Analysts and other investors must be confident that the numbers on which they base their investment decisions are realistic within the framework of the accounting model or they will be reduced to a feeling of being a part of a random process without knowing what is being done to them.

In the final analysis, the weighing of costs and benefits must represent a subjective judgment. The number of independent audits were growing prior to the Securities Act and it can therefore be implied that at least for many companies, a hard-nosed market judgment justified the cost of an audit. I believe this case is stronger today than it was at that time, but I guess in the final analysis one must have Faith--as I do.

If we agree that the principle of audits is a worthwhile one, we should explore next the question of whether or not things should be done differently. A number of suggestions have been made that perhaps there is a better alternative to the current approach of having independent accountants perform the audit function. Some have suggested that this should be a role for Government. Although in my current position I have developed a respect for the role of Government in the market place, I am not convinced this is the right answer. Government audits might be cheaper. I believe, however, that they would not be as creative, nor would they be as effective in avoiding abuses. A Government audit almost by its very nature is an adversary audit and the record of adversary audits in catching abuses is not very good. Such an audit discourages cooperation which is still the key to most audits. While the auditors of the Internal

Revenue Service, the Defense Contract Audit Agency, and the General Accounting Office achieve many successes, their overall record also shows the major difficulties which arise when the auditee is steadfastly trying to avoid working with the auditor. I believe, therefore, that Congress was wise in rejecting the idea of Government audits of companies offering their securities in the public market place.

Another possibility is to create an audit function within the corporation. The Audit Committee of the Board of Directors or some other internal source might supervise an internally performed function. I think, however, that it is apparent that not only would such auditors tend to lack breadth of expertise which comes to independent public accountants through experience with many companies but this approach would also be defective in those cases where management had reason for advocacy--at the bottom 5% of the cases where the auditor is most tested. This leaves us then with independent accountants, who I think can justify the faith which has been placed in them.

If we mutually agree that things should not be done differently, we should then consider the question of who should select the auditor. There have been numerous suggestions that if an outside party such as the Securities and Exchange Commission or the New York Stock Exchange were to select auditors they would not be so dependent upon the economic market place, and would be able to be more independent and less subject to the pressures of management. Once again, however, we can get to the question of whether the cost in terms of lack of cooperation in such audits would be greater than the benefits created by the lack of relationship. I am not persuaded that the benefits of such a system outweigh the very substantial problems that do exist with it.

Finally, there are questions raised as to who should pay for audits. Many of those suggesting that auditors be appointed by outside agencies also suggest some pooling of resources to pay audit fees. They suggest a New York Stock Exchange fee or some other device by which a pool of funds will be generated. While this again has some appeal, since the economic relationship between the auditor and his clients is one of the principal problems of appearance

that exists, I am doubtful that it would be an improvement. The discipline of the market place is still beneficial in the audit world and an auditor who did not have a responsibility to his client to do a good job in economic terms might well tend to over-audit. We should not encourage a steady increase in procedures simply because money is available. While there are problems with the current fee arrangements, I think that they represent as good a solution as any that have currently been proposed.

If we are to continue to operate within the current broad framework then we must determine what changes are required to improve the quality of audit work and avoid perceived problems. In the first place, a number of things can be done to increase auditors rights. While I would hesitate to suggest tenure, it would seem that a longer period of appointment might be beneficial. It is well known that during the first year of an audit, auditors generally absorb some significant nonrecurring costs. If the auditor could be assured of three, four or five years of audit relationships some economic pressures that might otherwise exist could be avoided.

Secondly, auditors should be given rights to attend meetings of board of directors and stockholders of the corporations. Corporate policy is set at directors meetings and if the auditor is to be fully apprised of what is going on and if his services are to be most productively used, his attendance at such meetings would be beneficial. Stockholders' meetings are generally attended by auditors today and the availability of the auditor to answer stockholders' questions, as well as to make a statement if necessary, seems desirable.

Third, there should be increasing pressure for mandatory audit committees comprised of board members to whom the auditor will have a direct channel of communication. This is not only a protection to the board but also an important right for the auditor since he is able to deal with members of the board on a continuing institutionalized basis.

Fourth, it might be desirable to permit the auditor to communicate directly to the shareholders whenever he feels it is necessary for him to do so. While such communications would be infrequent, it seems an appropriate lighting rod and device by which auditors could encourage greater corporate disclosure when they felt it was necessary. Such a right might be

implemented by the change in the SEC's proxy rules to require management to make a section in the proxy statement available to the auditor to enable him to make any statement to the stockholders which he feels necessary under the circumstances.

Finally, the auditor should have certain rights in regard to the disclosure of his dismissal. Our 8-K requirements currently represent a significant step forward in this regard but it may be that they should be extended to require disclosure in a proxy statement or annual report any time an auditor is changed. In addition, it might be that some public notice of auditor change should be required of any corporation beyond the simple 8-K requirement to report the hiring of a new auditor.

If auditors are to have more rights as I recommend, they should also recognize additional obligations. In this regard I believe that there is a need for increased use of the attest function. Auditors should be prepared, for example, to attest in some fashion to a company's internal control system and perhaps to forecasts or projections in some form.

In addition, the concept of auditor of public record needs development. Under this concept, the auditor has a continuing responsibility to review all public communications to investors and shareholders on a timely basis--not with the objective of performing an audit on interim and other data but to provide assurance that audited financial results are not being misused in press releases and annual reports and to be certain that accounting and measurement problems have been adequately aired prior to the publication of interim reports and other announcements. It is apparent that substantial work must be done in the development of standards in this area but the concept seems to be one which is growing in acceptance.

In the final analysis then, this re-examination of the role of the auditor has not created a cry for revolutionary change. Rather I believe that evolution of the auditor's role is essential and that the opportunities are very great for increased social service and function by the public accounting profession. Such increased opportunities should result both in increased revenues and increased responsibilities. As we see the tremendous growth in accounting registrations in schools of business today, we can perhaps take pleasure in the fact that students are voting with

their careers for a broader accounting function. If the profession avoids the paralysis which fear of liability can bring it and is prepared to see its role evolve, then both the public and the profession will be well served.