A STUDY OF RISK EVALUATION IN THE

AUDIT FUNCTION OF PUBLIC

ACCOUNTING FIRMS

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This study was concerned with the evaluation of relative risk in auditing by members of the eight largest national public accounting firms. There were two objectives of the study. The first was, through a review of the literature, to develop a relative risk function that identified the major factors which influence the relative risk of an audit engagement. The second objective was to interview representatives of the eight largest public accounting firms, both at the local and home office levels, to determine the extent to which the risk evaluation process has been rationalized by the profession. As part of the interviews, each respondent was asked to comment on the relative risk function developed from the literature.

For purposes of this investigation, relative risk was defined as the probability that any given audit engagement will eventually lead to some damage to the reputation of the accounting firm. In addition to a review of accounting, auditing, insurance and finance literature, the study gathered information on twenty-five lawsuits and disciplinary actions brought against the eight firms included in the interviews.

Facts gathered from all of the above sources led to the development of the relative risk function. The function states the relative risk of an audit engagement can approximately be determined by the reputation and stability of client's management, the client's system of internal control, the type of financing used by the client, the nature of the client's business, the client's rate of growth, the independence of the auditors and the longevity of the engagement.

The interview format was designed to cover a wide range of topics. Areas covered during each interview included new client investigation procedures, firm-wide working paper reviews, types of management advisory services offered, rate and method of each firm's growth, ability of practitioners to identify relatively high risk audit engagements, methods used to investigate a client's principals, types of internal control questionnaires used by each firm, the internal control evaluation process, various types of audit programs used by each firm and reactions to the relative risk function stated above. In addition, each interviewee was asked to rank the various factors, that he felt influenced relative risk, in order of importance.

The findings of the study showed that there was a process of risk evaluation conducted prior to each audit engagement. But, at best, the process is incomplete and generally implicit. Generally, each partner is allowed wide latitude in

judging the relative risk of each engagement. The determination of relative risk was left to the "professional judgment" of the individual partner rather than being determined by some formalized process. The degree of investigation of each risk factor varied from firm to firm and from individual to individual. All interviewees stated that the formalized relative risk function had merit and may prove useful to practitioners. As a group, the interviewees considered the reputation and stability of client's management as the most important risk factor. Next in order of importance was the nature of the client's business, followed by client's system of internal control, financing used by the client and client's rate of growth.

An explicit program for the evaluation of relative risk was developed based upon the information gathered from the literature and the interviews.

A STUDY OF RISK EVALUATION IN THE AUDIT FUNCTION OF PUBLIC ACCOUNTING FIRMS

DISSERTATION

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CHAPTER I

INTRODUCTION

Purpose and Significance of the Study

In recent years the accounting profession has faced a growing wave of criticism from many groups both within and without the profession. In general, this criticism is concentrated along two somewhat related lines. One line states that the generally accepted accounting principles which govern the accounting profession have failed to keep pace with the times and in many cases are inappropriate. The second form of criticism is that the work performed by public accountants in the course of an audit has become increasingly inadequate in light of the needs of statement users. Both types of accusations are extremely embarrassing to the accounting profession. However, quite different approaches have been taken by the profession to solve the underlying problems that have given rise to the criticisms.

Recently, the American Institute of Certified Public Accountants (AICPA) has established the Accounting Principles Board to study and offer opinions on various accounting principles. As originally conceived, the Board was to take a scientific approach to the solution of problems associated with accounting principles. The Board first would commission

a research study to gather all the facts available relating to a particular problem. The objective of the research study, usually headed by a prominent academician, would be to present the facts to the Board and to recommend a solution to the problem based upon the facts. The Board, after studying the facts and recommendations, would then issue a tentative opinion. This opinion would be widely circulated to members of the AICPA and other groups interested in the problem area. Reactions to the tentative opinion were then to be considered before the board issued its final opinion. This opinion meant that the solution to the problem was generally accepted by the profession and was to be incorporated into the set of generally accepted accounting principles.

This is how the Accounting Principles Board is to function in theory; in practice, the Board functions in quite a different manner. An excellent example of the functioning of the Board is offered in its recent opinions concerning business combinations and accounting for intangible assets.[1]

A research study was commissioned in the early 1960's to study the problems of accounting for business combinations. At the heart of the study was the question of "purchase versus

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[1]See _Opinions of the Accounting Principles Board 16 and 17_ (New York, 1970).

pooling" accounting. In 1963, the results of the study were published.[2] The study recommended that purchase accounting should be used in almost all mergers and set out the various cases where pooling-of-interests accounting would be appropriate. It was not until 1970 that the Board finally issued its opinion in the area of business combinations. While the requirements for pooling-of-interests accounting were tightened somewhat, the final opinion proved little different from the 1957 opinion of the Board's predecessor. The facts surrounding the opinion on accounting for intangible assets parallel closely those mentioned above. The problems are still waiting for a solution, and the criticism is still present.

As poor as the record of the Accounting Principles Board may be, at least there is an organized effort underway to reach solutions to some of the problems. The results of the past ten years are not without benefit.

When attention is focused on the second area of criticism, that directed at the adequacy of the work performed by public accountants, one finds no such organized effort to find solutions to the problems. Perhaps the most direct expression of the criticism leveled against public accountants can be found in the mounting number of lawsuits filed by

[2]Arthur R. Wyatt, _Accounting Research Study No. 5_ (New York, 1963).

clients and third parties. The claim in most suits is that the auditor attested to information in the financial statements that was false and/or misleading and that reliance upon these statements caused a financial loss to the plaintiff. While lawsuits serve as a source of embarrassment for the public accountants, they are by no means the only source. Many accounting firms and individual practitioners have faced disciplinary actions from governmental regulatory agencies and professional societies as a result of inadequate audits. The financial and business press as well as many leading professional journals have carried many articles in recent years about both the abuse of accounting principles and the inability of auditors to disclose the essential facts that they develop in the course of an audit.

A brief look at the history of lawsuits filed against public accountants can serve as a guidepost for viewing a change in attitude toward the profession. Prior to the late 1950's and early 1960's, most cases filed against public accountants proved unsuccessful. The courts were reluctant to broaden the accountants' liability in connection with their attest function. Liability was generally owed only to a client based on the contract existing between the auditor and his client. Many early cases, such as Landell v. Lybrand,[3] reaffirmed that accountants were not liable for negligence to

[3]264 Pa. 406 (1919).

third parties even if their audit report was incorrect. The first real change in the courts' position was issued by Chief Justice Cardozo of the New York Court of Appeals. He ruled in Ultramares Corporation v. Touche[4] that a fraudulent accountant could be held liable to third parties for damages. He emphasized that the auditor must act fraudulently rather than merely negligently, for to rule otherwise would be to "expose accountants to a liability in an indeterminate amount for an indeterminate class."[5] However, as a result of the decision, the courts became more and more willing to equate "gross negligence" with fraud, and thus offer legal remedies to third parties. At about the same time as the Ultramares decision, the Federal government enacted the Securities Acts of 1933 and 1934. These acts held accountants liable for any false or misleading information contained in the financial statements of a company filing with the Securities and Exchange Commission.

The law suits began to mount both in frequency and number of successful actions, and many of the cases received national publicity. Most of the major decisions of the 1950's and 1960's tended to increase the accountants' liability. At the present time, the situation has deteriorated to the point where it is extremely difficult to obtain adequate professional liability insurance at a reasonable rate for most public

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[4]174 NE 441 (1931). [5]Ibid., p. 445.

accountants. This new trend in court decisions seems likely to continue in the near future.

Public accounting is a profession which relies heavily upon the reputation and integrity of its members. To maintain their position as an independent third party, the public accountants' reputation must be beyond question. Any action which tends to damage their reputation may be disastrous not only to the individuals or firms involved, but also to the entire profession. The possibility of an audit engagement resulting in damage to a firm's reputation has become a serious problem for the profession. Each engagement subjects the firm to the risk of some type of adverse action. Before any rational decisions can be made about the acceptance of an audit engagement or the adequacy of the work performed during an engagement, something must be known about the risk involved.

It is the purpose of this study to examine the underlying nature of the relative risk associated with an audit engagement. The study is predicated on certain basic assumptions which are presented below.

Basic Assumptions

There are four basic assumptions made in the following pages. Some of the assumptions are rather complex and often difficult to follow by means of a verbal description.[6]

[6]For a more detailed explanation of these assumptions, see Jon Booker and others, "Some Propositions About Auditing," *Accounting Review*, XLV (July, 1970), 524-531.

Therefore, prior to the discussion of each assumption, a functional relationship will be presented to show the essence of the assumption. The use of such functions in no way implies any mathematical or measurable relationships, but is used solely for simplifying the presentation.

$$R = F(I/X_1, \ldots, X_n)$$

Where: R = Resource Allocation
I = Accounting Income
$X_1, \ldots, X_n$ = Other variables treated as constants

The first assumption is that the accounting measurement of income has real significance in the economic process of resource allocation. Classical economics teaches us that more efficient companies have lower costs and produce greater incomes. Therefore, in the capital markets, the more efficient producer receives more favorable credit terms than the less efficient producer. In this process, capital is allocated to the more efficient producers. This, of course, assumes the presence of a free and competitive capital market. The accounting measure of income can be used as an approximation of the economic concept of income. Therefore, in a classical sense, the greater the income of a company, the more efficient its operation. Income is assumed by some to be a measure of efficiency.[7]

[7]See the classic work in accounting, W.A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards (Evanston, Illinois, 1940), pp. 7-23.

The measurement of income is the responsibility of a company's management. The function of the audit is to lend reliability to the accounting measurements made by management. Without the assurance of the auditor's certificate, creditors could place little confidence in the income measurement. Without the attest function, the capital market would be disrupted. Therefore, like accounting, the audit function plays an indispensable role in resource allocation.

$$R_i = f(O_i / X_1, \ldots, X_n)$$

Where: R_i = Resource Allocation$_i$
O_i = Audit Opinion$_i$
$X_1, \ldots, X_n$ = Other variables treated as constants

The second assumption is that as a result of his examination, the auditor may issue any one of a set of graded opinions. Furthermore, each opinion in the set has a different impact upon resource allocation.

While it is presumed at the outset that a given audit engagement will result in an unqualified opinion, the auditors are not restricted to any one type of opinion. The unqualified opinion states that in the opinion of the auditors, the financial statements "present fairly" the financial position of the company and the results of operations for the period reported. The opinion further states that the financial statements were prepared in accordance with "generally accepted accounting principles," and that the principles were applied

on a basis consistent with last year. The unqualified opinion is the most desirable from the viewpoint of management.

Next in order of desirability is the qualified opinion. It is necessary for the auditor to render a qualified opinion where the scope of the audit is limited by circumstances beyond his control, or when the financial statements do not present fairly the financial position and/or results of operations of the company, or when uncertainties about the future cannot be resolved or their impact estimated. The qualified opinion has two general forms. A "subject to" qualification is generally rendered when the outcome of some material future event cannot be estimated by the auditors. For example, the company may have a number of lawsuits filed against it, and the final disposition of these suits could have a material effect upon the financial statements. In this case, the auditors may qualify their opinion subject to the resolution of the suits. Disclosure of the reasons for this type of qualification are given in the footnotes to the financial statements. The second general type of qualification is referred to as the "except for" qualification. This type of qualification results when the company has made some change in accounting procedures that has a material effect upon the financial statements. For example, a qualification would be in order if a client changed its procedure from expensing research and development costs to capitalizing the costs and charging

a portion of these costs to income each year. The auditor's opinion would state that the financial statements had been prepared on a basis consistent with prior years except for the change in accounting for research and development costs. The opinion must note the exception, and adequate disclosure should be made of the effect of the change upon the financial statements, with particular emphasis on the income reported.

The next opinion in order is the piecemeal opinion. This type of opinion results when the auditors find it necessary to disclaim an opinion or to give an adverse opinion on the financial statements in general. The piecemeal opinion is an effort to express an affirmative opinion on those parts of the financial statements which the auditors feel are fairly represented. For example, a piecemeal opinion may state that certain assets and certain liabilities are presented fairly, but disclaim an opinion on the remaining financial statement items.

Following the piecemeal opinion is the disclaimer of opinion. The disclaimer simply states that the auditors are not able to express an opinion on the fairness of the client's financial statements. A disclaimer of opinion generally arises from some limitation on the scope of the audit or highly significant uncertainties about the future that cannot be resolved by the auditors to their satisfaction.

The final general type of opinion is the adverse opinion. This type of opinion states that the financial statements do not present fairly the financial position or results of operations of the client.

Within each of the five broad types of opinions, there exists a large number of possible opinions that may result from a given audit engagement. Nonetheless, it is assumed that the sophisticated statement user is able to distinguish between the various types of opinions in making an investment decision.

$$O_i = f(E_i / X_1, \ldots, X_n)$$

Where: O_i = Audit Opinion$_i$
E_i = Audit Evidence$_i$
$X_1, \ldots, X_n$ = Other variables treated as constants

The third assumption is that the audit staff is able to determine the quantity and quality of evidence necessary to sustain each type of audit opinion. Under given circumstances, auditors are able to associate a given set of evidence with each type of opinion. Certainly the set of evidence necessary to sustain an unqualified opinion is not the same as the set of evidence necessary to issue a disclaimer of opinion or an adverse opinion.

$$E_i = f(C, O, I, H, F, R / X_1, \ldots, X_n)$$

Where: E_i = Audit evidence$_i$
C = Custom and authoritative pronouncements

O = Nature and size of client's operation
I = Client's system of internal control
H = Audit hierarchy
F = Fee constraint
R = Relative risk of the audit
$X_1, \ldots, X_n$ = Other variables treated as constants

The final assumption is concerned with the determinates of the evidence required to issue a given audit opinion. It is assumed that the quantity and quality of evidence to be gathered on any given engagement can be approximately determined by custom and authoritative pronouncements, the nature and size of a client's operations, the client's system of internal control, the audit hierarchy, the fee constraint, and the relative risk assigned to the audit engagement. For purposes of clarity, a brief description of each of the factors in this rather complex relationship is presented below.

There can be little doubt that custom plays a part in the evidence gathering function of the auditors. Witness the fact that on all repeat engagements, a set of the prior year's working papers are used extensively by the auditors, or the claim by some that audit programs do not change substantially from year to year.

Likewise, authoritative pronouncements influence the quantity and quality of the evidence gathered by the audit staff. Perhaps the most influential pronouncements are

those of the Committee on Auditing Procedures of the American Institute of Certified Public Accountants. Statements of this committee cover important areas of the auditors' evidence gathering and documentation procedures. While customs and pronouncements influence the auditor, this is not to say that auditing is entirely an habitual activity.

The size and nature of a client's operations are important factors in the evidence gathering process. Certain types of assets are inherently more difficult to audit than other types of assets. For example, it is generally easier to audit physical assets than to audit claims which represent assets. For the most part, the larger and more diversified a client's operations, the greater the quantity and/or higher the quality of evidence that must be gathered to sustain a given opinion. While there is probably a direct relationship between size and evidence gathered, the relationship is probably not proportional.

The client's system of internal control is perhaps the most widely publicized factor in the relationship presented above.[8] The second standard of auditing fieldwork requires that there be "a proper study and evaluation of the existing

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[8]Internal control is generally defined as "comprising the plan of organization and all of the co-ordinate methods and measure adopted within a business to safeguard its assets, check the accuracy and reliability of its data, promote operational efficiency, and encourage adherence to prescribed managerial policies." See _Accounting Research Study No. 7_, "Inventory of Generally Accepted Accounting Principles for Business Enterprises," (New York, 1965), pp. 34-38, for a more detailed explanation.

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."[9] Therefore, the AICPA makes it mandatory to review internal control and use the results of this review to set the scope of the audit work to be done. Standardized programs for the review of internal control have been developed by most accounting firms. It is presumed that the more effective the system controls, the more the auditor can rely upon the system, and thereby minimize the evidence to be gathered. A weaker system would require a greater quantity or a higher quality of evidence to sustain the same opinion.

The structure of the typical audit hierarchy influences the volume and kind of evidence that is gathered during an engagement. The typical audit staff is triangularly shaped. The untrained and inexperienced junior accountants compose the base of the triangle. Each successive layer in the triangle constitutes a smaller proportion of the total staff, but is composed of more highly trained individuals. However, it is the junior accountants who do most of the actual evidence gathering. Because of their lack of experience, the junior accountants are not deemed qualified to determine the kind or volume of evidence that must be gathered on any given audit proposition. The evidence to be gathered must be carefully programmed in advance, and the function of the junior accountant is to collect the evidence called for in the audit

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[9] *Auditing Standards and Procedures*, (New York, 1963), p. 16.

program. As a result of the pre-programmed nature of the audit, too much or too little evidence may be gathered.

The fee constraint is a very real determinate of the evidence gathered. It can be assumed that most companies treat their audit fee as any other ordinary business expense. Therefore, in the long run, most clients will attempt to minimize their audit fee, given certain qualitative constraints.[10] The size of the audit fee places a constraint upon the amount of evidence that can be gathered. If the accounting firm cannot gather the evidence it deems necessary because of a client-imposed fee constraint, it would be forced to give up the client, or issue a low-grade opinion, which often means losing the client.

The relative risk which the auditors assign to any audit engagement also influences the evidence to be gathered. If the risk of adverse action is thought to be relatively high, they will collect a higher quality and/or greater quantity of evidence. Where risk is thought to be relatively low, a minimum amount of evidence is needed on any given audit proposition. It is the purpose of this study to examine in depth the relative risk factor.

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[10]For example, a large company would not generally employ a small local or regional firm. The problem of independence may become acute if one client were to account for, say, fifty per cent of the total revenues of an accounting firm. The very large companies may therefore attempt to minimize the audit fee by choosing from among the top eight or twelve accounting firms.

Statement of Hypothesis

It is the hypothesis of this study that there is an evaluation of relative risk prior to each audit engagement which is one of the determinates of the quantity and quality of evidence gathered. The term "relative risk" is defined as the probability that any given audit engagement will eventually result in some damage to the reputation of a public accounting firm.

Methodology

To identify the factors that accounting firms should be considering in the process of risk evaluation, an extensive review of the literature was undertaken. In addition to accounting and auditing literature, the review included recent litigation and disciplinary actions against accounting firms as well as literature from the field of insurance and risk.[11] This review lead to the development of a broad relative risk relationship which is discussed in detail in Chapter II. The relationship includes the major determinates of relative risk associated with a given audit engagement.

After the relative risk relationship was developed, personal interviews were conducted with responsible individuals in the major national accounting firms. The primary purpose

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[11] See Appendix A for a detailed review of the recent law suits and important disciplinary actions against public accountants.

of these interviews was to ascertain the extent to which risk evaluation has been rationalized by the profession. The secondary purpose was to obtain the reactions of practitioners to the relative risk relationship.

Personal interviews were limited to individuals representing the so-called "Big Eight" public accounting firms.[12] These firms are the largest and most influential in the profession. They have the resources to devote to the problem of risk evaluation. As an example of the dominance of these eight firms in the public accounting profession, it has been noted that they audit approximately ninety per cent of all companies listed on the New York Stock Exchange.[13]

The results of the personal interviews are discussed in Chapter III, and Chapter IV contains the summary and conclusions.

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[12]The firms included in the "Big Eight," and their home offices are as follows:

Firm	Home Office
Arthur Andersen & Co.	Chicago, Illinois
Arthur Young & Co.	New York, N. Y.
Ernst & Ernst	Cleveland, Ohio
Haskins & Sells	New York, N. Y.
Lybrand, Ross Bros. & Montgomery	New York, N. Y.
Peat, Marwick, Mitchell & Co.	New York, N. Y.
Price Waterhouse & Co.	New York, N. Y.
Touche, Ross & Co.	Chicago, Illinois

[13]See "The Big Eight Accountants: How Far Should They Go?" <u>Corporate Financing</u>, VI (January/February, 1970), 34-39, where John Lyons stated that of the 1275 firms listed on the New York Stock Exchange, 1132 were audited by members of the Big Eight.

CHAPTER II

THE RELATIVE RISK RELATIONSHIP

The purpose of this chapter is to document and discuss the development of the relative risk relationship shown in Chapter I. The relationship was developed from a careful review of the literature, legal and disciplinary actions involving public accountants, and discussions with academicians and practitioners. The true test of the validity and usefulness of the relationship rests in its acceptance and implementation by practicing accountants.

For sake of simplicity, the risk relationship is presented below in the functional form used in mathematics. By so doing, it is not intended to imply that a precise and measurable relationship exists between relative risk and the various factors that tend to influence the degree of this risk; rather, it is presented to give the reader an abbreviated look at the main topic of discussion in this chapter.

$$\text{Relative Risk} = f(B, R, I, C, F, G, L/X_1, \ldots, X_n)$$

Where:
- B = Nature of the client's business
- R = Reputation and stability of client's management
- I = Independence of the auditor
- C = Client's system of internal control
- F = Type of financing used by client
- G = Client's rate of growth
- L = Longevity of the audit engagement
- $X_1, \ldots, X_n$ = Other variables treated as constants

As in most functional relationships there are several variables that can not be identified or isolated. In the above relationship, these are represented by the factors X_1 through X_n, which for purposes of this study are treated as constants. As more and more knowledge is gained about the risk function, it will be possible to incorporate some unknowns into the relationship. However, knowing that we are dealing with a social science, it is doubtful that one will ever be able to identify all of the factors that influence relative risk.

As to the methodology used in this chapter, the function will be altered so as to treat one factor at a time, holding the other factors constant. For example, when the nature of a client's operation and its effect upon relative risk is being discussed, the reader should mentally change the relationship to read as follows:

$$\text{Relative Risk} = f\ (B/R,\ I,\ C,\ F,\ G,\ L,\ X_1,\ .\ .\ .\ .\ ,\ X_n).$$

When the discussion is concerned with the interrelationships of the various factors, the reader should mentally change the function to incorporate two or more of the factors. For example, there may exist a certain relationship between the longevity of an audit engagement and the independence of the auditor. Therefore, the functional relationship may appear to be:

$$\text{Relative Risk} = f\ (L,\ I/B,\ R,\ C,\ F,\ G,\ X_1,\ .\ .\ .\ .\ ,\ X_n).$$

Again, it should be emphasized that the presentation of the risk relationship in a functional form is in no way intended to imply a precise and quantifiable relationship between risk and the factors identified for discussion in this paper.

Risk Defined

As stated in the introduction, the term "relative risk" is defined as the probability that a given audit engagement will result in some damage to the reputation of an accounting firm. At this point, it is necessary to expand somewhat on the definition presented above.

As Dickerson has so aptly stated, "It is a truism that the injury to an accountant's professional reputation which can result from a successful claim against him for negligence will often be far more serious a matter than the money damages he may be required to pay."[1] We must assume that at some point in time a firm's loss of reputation will result in the loss of clients and therefore a loss in revenue. Whether or not this is a valid assumption remains the topic for further research in this area. However, it does seem logical that a firm held in low regard by the financial community will not have as many clients referred to them as a firm with an unblemished reputation. One might therefore conclude

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[1] R. W. V. Dickerson, *Accountants and the Law of Negligence* (Toronto, 1966), p. 63.

that rather than suffer a loss in revenue, the firm with a damaged reputation would not experience as rapid an increase in clients and fees as a firm with a better reputation. In either case, it is possible to equate loss of reputation with loss in clients or potential clients and, therefore, fees.

Another idea inherent in the definition of risk is that a firm need not be guilty of any misconduct to suffer a loss of reputation. The financial press has often linked the name of a public accounting firm with the collapse or bankruptcy of a business, implying in some way that the firm was responsible or contributed to the downfall, even though available facts could prove no misconduct on the part of the auditors. As an example, witness the recent adverse publicity received by Peat, Marwick, Mitchell & Co. in connection with the bankruptcy of the Penn-Central Railroad. The portrayal of facts by _Fortune_ proved to be groundless with respect to the accounting firm, and resulted partially from the writers' lack of accounting knowledge.[2] In the following month's edition of _Fortune_, the managing partner of Peat, Marwick, Mitchell & Co. told his side of the story in the "Letters to the Editor" section of the magazine.[3] However, the damage had been done in the original article, and the reply by Peat,

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[2]Rush Loving, "Penn Central Bankruptcy Express," _Fortune_, LXXXII (August, 1970), 104-109.

[3]W. E. Hanson, "Letters to the Editor," _Fortune_, LXXXII (September, 1970), 87-88.

Marwick, Mitchell & Co. did not appear to offset any of the adverse publicity. This is an example of an auditing firm's suffering damage to its reputation, even though the firm was innocent of most, if not all, of the allegations made in the press.

To further amplify this line of thought, several lawsuits against public accountants received widespread publicity in the financial press, and upon further research it was found that the cases were dismissed by the trial judge as groundless.[4] However, the fact that the cases had been dismissed received no mention in these publications. This may lead a reader to conclude that all actions brought against public accounting firms are successful. In any case, it tends to damage the reputations of the firms involved as well as the reputation of the entire profession.

The above comments are not to say the auditing firms have been blameless in all legal and disciplinary actions brought against them, but rather that a firm's reputation can suffer even though the charges against that firm are groundless.

The word "reputation" in the definition of risk also presents some problems that need to be clarified. Each firm may view its reputation in a different light. For example, one firm may believe itself to be a leader in the

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[4]Here reference is made primarily to The Wall Street Journal, Barrons, and Business Week.

profession, continually advancing new ideas and concepts. Any firm that takes this position is bound to receive a great deal of criticism from other auditing firms and the financial press. In the past few years, these firms have been labeled "liberal" in terms of their approach to auditing and their application of accounting principles. A firm in this position is willing to accept attacks upon its reputation, because it has assumed what it thinks to be a leadership position. The self-image of the firm's reputation may be quite different from that of other firms in the industry. Each firm probably has a different idea as to what its image is or what it ought to be.

However, for purposes of this study, it is assumed that the word "reputation" can be associated generally with all of the "Big Eight" firms without attempting to differentiate the individual concepts of reputation within each of the various firms. Also for purposes of this study, the word "reputation" is used in its broadest sense to mean public esteem.

The final word in the definition which needs some clarification is that of "probability." It might be safer to substitute the word "possibility" in place of "probability" since the latter connotes a degree of measurability, as used in the statistical sense. The word "probability" was chosen, however, for at some time in the future when more facts are gathered, one may be able to associate a probability

with the degree of risk involved in the audit engagement. At the present time, it is impossible to attain this degree of sophistication. Before moving on to the main topic of this chapter, it is necessary to digress for some brief comments concerning the approach to risk evaluation used in the insurance industry.

Insurance and the Problem of Relative Risk

Because the insurance industry offers the practicing accountant professional liability insurance, one might assume that the underwriters are well aware of the factors which influence the auditors' relative risk. In an effort to determine the extent of their knowledge concerning risk and the underwriting of accountants' professional liability insurance, several major companies were contacted and asked the following questions:

> (1) What factors or variables are considered by the underwriters before a premium can be established for accountants' liability insurance? (How do you determine the risk factor?)
> (2) How do you gather information about these factors?
> (3) Who do you consider to be the major underwriters of accountants' Professional Liability Insurance? (By 'major' it is meant underwriters who handle policies in excess of $1,000,000.)[5]

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[5]A list of the companies that replied to the inquiry include: (1) National General Agency, Inc.; (2) The Continental Insurance Companies; (3) Lloyd's Underwriters' Non-Marine Association; (4) J. H. Minet & Co. (North America) Ltd., an associate of Lloyd's Underwriters.

Through correspondence with several underwriters, it was determined that Accountants Professional Liability Insurance was designed to cover liability caused by neglect, error or omission, dishonesty, misrepresentation or fraud, civil libel, slander or defamation of character.

The factors considered when underwriting such a policy include the following:

(1) Names of all principals and partners of the firm
(2) Whether or not they are Certified Public Accountants and if so, how long they have been certified
(3) When the firm was established
(4) The number of persons employed on the professional staff
(5) Prior insurers and losses or any past incidents which might give rise to a claim.

The total premium is based primarily on the number of professional staff employed by the firm. The basic liability policy excludes coverage under the provisions of the National Securities Act of 1933. However, this exclusion could be waived for an additional ten per cent of the basic premium. All of the information required to underwrite the policy is furnished by the accounting firm. In the responses received, there was no indication that any additional information is gathered by the insurer before the policy is written. All of the "Big Eight" firms are insured through Lloyd's of London, who was one of the respondents to the questions.

On the basis of the responses received, there are several very unusual facts which should be noted. First, it appears

that the underwriters are not concerned with the types of clients audited by the accounting firm insured. There seems little effort to gather more than the most routine information from the accounting firms. The really meaningful information would be that connected with the past losses or situations that might have given rise to a claim; however, none of the respondents went into any detail in connection with this factor. In fact, two of the respondents, Lloyd's Underwriters and J. H. Minet Co., Ltd., specifically stated that this was privileged information between the insured and the underwriter.

Again it seems strange that coverage under the 1933 Securities Act is available at only an additional ten per cent of the basic premium. This is especially peculiar when considered in light of the fact that the majority of the cases detailed in Appendix A involve alleged violations of the Securities Acts of 1933 and 1934.

Throughout the course of the past five years, a whole new area of insurance has developed in connection with Securities and Exchange Commission liability insurance. In essence, the policy is written to cover one particular issue of stocks or bonds that are registered and sold to the public. The policy covers the time from the date of registration until the statute of limitation expires for filing claims in connection with the issue. (The general policy usually

covers from thirty-eight to thirty-nine months.)[6] Again, Lloyd's of London is the primary underwriter of SEC Liability Insurance. This type of coverage is available for underwriting firms, stockbrokers, directors and officers and investment trusts; however, accountants are not eligible for this particular type of coverage. The policy specifically states that "It is not feasible from the standpoint of insurers to include accountants or other experts under the SEC policy."[7] Accounting firms must rely exclusively upon professional liability insurance.

Through discussions with the Vice President/General Manager of one of the insurance underwriting firms, it was learned that the determination of an insurance premium to charge a specific accounting firm was a very difficult task. The primary problem facing the underwriters is the lack of a statistical base that can be used in deriving a premium. Generally, a rate is set by the industry and is then varied either up or down depending upon the losses that are experienced. In the past, the trend has been that the initial rate tended to drop in the first few years the policy was in force. Then, as losses started to be incurred, the rates were

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[6]For more explicit information regarding SEC liability coverage, see The National Underwriter, LXXII (December 6, 1968), 8, part 2.

[7]Frederick A. Palm, "SEC Liability Insurance--A Field with Rising Interest," The National Underwriter, LXXII (December 6, 1968), 47.

adjusted upward. The reason given for this trend is the length of time that is currently required to settle losses under the policies.[8]

A discussion of professional liability insurance in the areas of engineering and architecture adds credibility to the comments of the above source.

The following quotation from an article summarizes the efforts of insurers to establish liability premiums:

> Because of the lack of a statistical history for the setting of insurance rates when the professional liability policy was issued, rates were fixed on the basis of several educated guesses (emphasis added). Claims for the first two or three years after the inception of the commended policy form were minimal; therefore, the insurance company concluded its arbitrarily set premiums were too high.
>
> So, the rates were reduced. Unfortunately, however, a two- or three-year lag was found between the time this class of insurance goes into effect and the appearance of claims. Claims appear upon the inception of construction and remain fairly stable for about two or three years, when a substantial increase occurs.
>
> Thus, at the end of the third year of the program, claims had grown to the point where it was obvious that losses would increase. Losses did occur and it became necessary for rates to be increased.[9]

The rates on all professional liability insurance have increased substantially during the past five to ten years.

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[8]For substantiation of these comments, see D. Guerrini Muraldi, "Professional Liability: How Long Can Insurers Play Santa Claus?" The National Underwriter, LXXII (December 6, 1968), 20.

[9]George M. White, "Professional Liability Insurance," American Institute of Architects Journal, IX (January, 1966), 49.

The latest rate increases found in the literature indicate that lawyers' professional liability insurance rates were increased 100 per cent in 1969, while physicians' and surgeons' rates have increased 22.6 per cent, and dentists' liability rates have increased 66.7 per cent.[10] These rates represent one-year increases, and it is not known if the increases are this substantial every year.[11] From discussions with several local practitioners, it was learned that the rates for accountants' professional liability insurance have increased at least as fast as the premium rate increases in other professions. However, they were reluctant to discuss specific percentage increases or actual cost of their firms' liability coverage.

Some further comments are in order as to the extent of coverage that is adequate for the large accounting firms. It has been suggested that the coverage under an accountant's professional liability policy be at least two and one-half times the gross billings of the firm.[12] As several of the larger international firms have gross billings in excess of $100,000,000, this would mean carrying a policy of about

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[10]"Professional Liability Rates Are Increased in Numerous States," The National Underwriter, LXXIII (March 7, 1969), 23.

[11]For similar problems facing contractors and design engineers, see "Professional Liability Risk Grows; Cover Hard to Get," The National Underwriter, LXX (August 26, 1966), 4.

[12]P. J. Hughes, "Auditors' Liability," The Accountant, XXC (October, 1969), 740.

$250,000,000. In the first place, it is doubtful that any firm could obtain such a large policy even from a large group of underwriters; secondly, the cost of such a policy would be quite substantial. This suggested guideline seems entirely out of line with reality.

Other suggested coverage is mentioned in the literature that is considerably below the recommendations presented above. For example, it has been stated that "Although coverage is becoming increasingly difficult to obtain, individual (firm) coverage has approximated as high as $15,000,000."[13] Even considering this amount as the lower limit of available insurance coverage, it appears to be wholly inadequate in today's financial world. In several of the cases outlined in Appendix A, the plaintiffs have sought damages well in excess of $15,000,000.[14]

As a result of research in the area of accountants' professional liability insurance, it appears that the insurance industry is perplexed over the nature of the auditors' risk, and to date have not conducted any studies to determine the causes of risk on a particular audit engagement or the risks faced by the entire auditing community.

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[13]Michael W. Frye, "Extending Accountants' Professional Liability," The National Public Accountant, XIV (February, 1969), 17.

[14]See American Institute of Certified Public Accountants, "Bulletin 10-Insurance for Accounting Firms and Practitioners," Economics of Accounting Practice (New York, 1959), pp. 5-6, for the rather meager coverage available through state Societies and the American Institute.

For some industries, insurance companies have developed ideas to prevent the incidence of losses, i.e., hard-hats required in the construction industry. The field of public accounting is still waiting for some suggestions as to how to reduce its incidence of loss.

Public Accounting and the Concept of Self-Insurance

A topic for consideration directly related to professional liability insurance is that of self-insurance by the practicing accountant. If the auditors believe a given audit engagement to be relatively high risk, they will gather a higher quality or greater quantity of evidence for any given audit proposition. The increased time and effort spent by the auditors in the evidence gathering process can be thought of as a form of self-insurance. The increased fees that result from the additional work would then be an approximation of the cost of self-insurance that is recovered by the auditors.

However, there are several serious defects with this concept of self-insurance. Perhaps the most serious defect is that it assumes that the auditors are consistently able to identify relatively high risk engagements. If the auditors are unable to systematically identify high risk engagements, then in effect there would be little or no self-insurance through extended audit procedures. Another major problem facing the auditors would be the determination of the extent

to which procedures should be extended on a given audit engagement. If relatively high risk engagement could be identified, but the auditors failed to properly extend their audit procedures, self-insurance would be inadequate. A final factor that would tend to reduce the effectiveness of the auditor's efforts to self-insure is that most clients resist substantial increases in audit fees. Management is relatively free to change auditors at any time. If the management believes the audit fee to be out of line, it can employ another accounting firm which may be able to complete the audit at a lower cost.

The above comments are made solely to point out that the difference between the "normal" audit fee and the "risk adjusted" fee would not be adequate to constitute a meaningful attempt at self-insurance.

With a rational process of risk evaluation, the above concept is not without merit, and supplemented with adequate professional liability insurance, can provide the practitioner with some protection in the event of adverse action developing from a given audit engagement.

The Relative Risk Factors

Saul Levy, one of the most esteemed writers in the area of accountants' liability, has made the following statement which serves as a guidepost for the discussion of the factors which influence relative risk:

> In defending our audit work, we have to contend with the menace of hindsight wisdom. It is always available to our critics. They know what finally happened, and so they know what leads to follow in their search for evidence of negligence. . . . Mindful of all this, we must cultivate a type of thinking which anticipates these hindsight possibilities and seeks to provide a defense against them. When a road ahead is on the other side of the hill or around a bend, we visualize the possibility of traffic or a roadblock on the unseen road ahead. In our audit work, we can minimize the hazard of hindsight wisdom only by developing a technique of imaginative thinking which foresees the possibility of future adverse developments and tests the adequacy of audit procedures in that light. Call it, if you will, 'anticipatory hindsight.'[15]

It is hoped that through the further development of the relative risk relationship, the profession as a group will be able to begin following Levy's suggestion that it develop "anticipatory hindsight." The purpose of risk evaluation is to anticipate potential problems and, where possible, to compensate for them by the use of differing audit procedures. Where the problems appear too great, the only solution may be to refuse the audit engagement.

The current auditing literature offers little to the practitioner in the way of concrete suggestions for the development of the much needed "anticipatory hindsight." As a sample of what one may find in the literature, Joe R. Fritzemeyer offers the following seven suggestions for minimizing the risk of liability:

> (1) Carry an adequate amount of insurance.
> (2) Never sign your name to or otherwise associate yourself with a financial statement which you know to be false or misleading.

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[15] Saul Levy, "Legal Hazards in Public Accounting," *The Journal of Accountancy*, XCIX (May, 1955), 38.

> (3) Make clear exactly what it is that you have undertaken to do . . . put the terms of the engagement in writing.
> (4) See to it that the engagement is carefully performed. Here is a simple slogan: Be careful at all times.
> (5) Know your client and, to the extent possible, avoid undertaking or continuing engagements with clients whom you believe to be untrustworthy.
> (6) Make clear what you have done and, where appropriate, what you have not done. It is when you have done something different from a standard engagement that the language on your report can be critical.
> (7) Keep in mind that the third party, who may be expected to read your report is a mythical creature called the 'reasonable man.' Be sure therefore that you say nothing in your report which is not perfectly clear, not only to your peers in the profession, but to a jury of 12 good men and true.[16]

While Fritzemeyer, no doubt, had the best intentions in offering these suggestions to the profession, they present nothing new of meaningful value to the practitioner. Practitioners are well aware of the facts that they need to carry insurance, be careful in their audit work, not deal with untrustworthy persons, etc. Fritzemeyer is by no means the only writer to offer such nebulous and often meaningless advice. The profession is in dire need of explicit facts, not vague generalities.

The cases outlined in Appendix A represent the results of an extensive review of the literature. Because of the sensitive nature of lawsuits and disciplinary actions against professional accountants, it was impossible to obtain access to individual firm files relating to such actions. Contacts

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[16]Joe R. Fritzemeyer, "Seven Rules for Minimizing the Risks of Liability," The Journal of Accountancy, CXXVII (June, 1969), 64-65.

with leading members of the American Institute of Certified Public Accountants proved to be of no help in gathering the much needed facts. Efforts were made to have all the "Big Eight" firms funnel their information through a highly regarded educator, who would then eliminate all references to the firm or individuals involved. This would have provided the facts needed without direct identification of the various firms or companies participating. However, this effort was unsuccessful as the firms did not wish to cooperate. After all efforts to obtain the facts from the accounting firms failed, the review of the literature was undertaken. These case histories represent a pool of information which had not previously existed. The facts gathered through the review of the literature provided the background needed to develop the relative risk relationship.

The Nature of a Client's Business

Most current auditing textbooks and much of the auditing literature could be classified as "how to" material.[17] As proof of this generalization, one has only to look through the tables of contents of the most widely used auditing textbooks. A brief introduction is in most cases followed by the procedures used by the auditors to audit the various

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[17]Excluded from this generalization is the work of R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (New York, 1961). The book represents an attempt to explore the meaning of auditing.

balance sheet and income statement accounts. Technique is considered in depth, while the meaning of the entire audit process is generally treated in one or two short chapters.[18] After reading several of the popular auditing textbooks, one might easily get the impression that all audits are very similar and the same techniques are applied with slight modifications to all audit engagements. Only slight and implicit recognition is generally given to the differing audit environment posed by different types of industries or different types of businesses.

In practice, however, this is not the case at all. Before each audit engagement, the in-charge personnel (senior through partner) must become fully aware of any auditing or accounting variations associated with the business that they are likely to face in the course of the audit. Different types of businesses present different problems to the auditors, and failure to recognize these differences can be detrimental to the firm. In fact, the type of business being audited determines the extent to which certain audit procedures will be followed. All businesses are not treated the same by the auditors. "The key to the discovery of major

[18]To confirm the nature of current auditing textbooks, the reader is asked to examine such books as Principles of Auditing, by Walter B. Mergs; Basic Auditing Principles, by Arthur W. Holmes; Montgomery's Auditing, by N. J. Lenhart and P. L. Defliese.

accounting and auditing problems lies not in the accounts themselves, but rather in an understanding of the business being audited."[19] This quotation summarizes what has come to be known as the "business approach to auditing." This approach places more emphasis on a thorough knowledge of a client's business than on the audit techniques used to examine the various accounts. The auditing profession has recognized the importance of distinguishing between various types of businesses and industries.

To further amplify on the degree to which this business approach is in effect today, during the course of research, one public accounting firm made available its industry study program. In the introduction to the program, the following objective was stated:

> Substantive knowledge and understanding about the client's industry--its distinctive characteristics, problems, etc.--affords the only sound foundation for the effective discharge of any assignment. With such background, for example, audit scope can be established to emphasize the areas of exceptional exposures (emphasis added) which are peculiar to each industry; financial reports and analyses will be most intelligently prepared and interpreted in light of general industry conditions and developments.[20]

The program is divided into 27 industry divisions and sub-divided into 272 individual industries. General

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[19]Harry W. Kirchheimer, "The Business Approach to Auditing," The Oklahoma CPA, V (October, 1966), 15.

[20]The firm has asked that it not be identified in this paper, as it may be construed by some as a form of advertising.

information is then gathered on each of the industry divisions and as many subdivisions as possible. This information is available at each local office and can be reviewed before and during the planning stage of the audit.

The general information gathered on each industry in the program includes the following:

(1) Background and operations

(2) Economics

(3) Current data

(4) Accounting, auditing and tax problems

(5) Firm industry experience

(6) Regulations

Within each of these broad general information categories, specific information is gathered as follows:

(1) Background and operations
- (a) Labor costs and automation
- (b) Marketing techniques and practices
- (c) Government regulations
- (d) Financing problems and capital requirements
- (e) Raw material supply
- (f) Domestic and foreign competition
- (g) Technological progress
- (h) Obsolescence
- (i) Consumer demand

(2) Economics
- (a) General information regarding the economics of the industry

(3) Current data
- (a) Working capital
- (b) Debt to equity
- (c) Return on net worth
- (d) Return on total assets
- (e) Gross profit
- (f) Net income to sales

(4) Accounting, auditing and tax problems
    (a) Review of available information as well as firm knowledge in this area

(5) Firm industry experience
    (a) Correlate the economic and business problems of an industry with accounting and management aids developed by the firm to assist in the solution or correction of these problems

(6) Regulations
    (a) Types of governmental or other regulation prevalent in the industry

Contrary to what is found in the majority of auditing texts, the intelligent auditors give explicit recognition to the nature of the business they are about to audit.

Further proof is also available to show the explicit recognition of differences in business operations and the auditing problems that they may create. Prior to the personal interviews, members of all "Big Eight" accounting firms were contacted and specifically asked if they had developed specialized internal control questionnaires for different types of businesses or industries. If such questionnaires had been developed, they were asked to list the several different types used. All of the firms responded to the inquiry, and six of the eight firms indicated that they had developed several different questionnaires for different types of industries.[21] These questionnaires are primarily designed for industries with specialized auditing

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[21] See Chapter III, p. 96, for a common list of such questionnaires.

and accounting problems. The questionnaires call to the auditors' attention certain areas of "high exposure" that may require careful audit planning.

To this point it has been shown that auditors do draw very explicit distinctions between various types of businesses. The question that remains to be answered is: Why are these distinctions felt to be so important?

The answer presented in this study is that the nature of a client's business influences the relative risk of the audit engagement. To better understand the nature of the risks that the auditors will assume, specific knowledge must be gathered about the various business enterprises they will be called upon to audit. "Each business has recurring risks of which the auditor must be aware and should review each year."[22] Any area of risk in the business presents an area of risk in the audit of that enterprise. It is interesting to note that the objective of the industry study program mentioned above relates the type of audit procedures to be used to the areas of "exceptional exposure." "The very nature of some assets makes the risk of misstatement greater than for others."[23] Therefore, a client with a material amount of "high risk"

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[22]M. O. Alexander and D. S. Wells, "A New Look at the Extent of Audit Work," Canadian Chartered Accountant, XCII (May, 1968), 325.

[23]Walter B. Meigs and E. John Larson, Principles of Auditing (Homewood, Ill., 1969), p. 145.

assets would probably be considered a "high risk" client by the auditors. The asset composition is not the same for all businesses.

The inherent characteristics of some businesses cause them to be classified as "high risk" type operations. High risk is used here in two different senses: There is a high probability that the financial statements may be materially misstated, and past experience has shown that this particular type of business has a high incidence of failure. In either case the risk to the auditor is high, as several lawsuits have developed from either cause. From the facts available in this study, it can be concluded that the companies in the finance industry tend to be high risk engagements as far as the auditor is concerned.

Three of the six companies having different industry questionnaires have designed questionnaires for finance companies (not including banks or savings and loan institutions), and six of the lawsuits or disciplinary actions listed in Appendix A involve finance or finance-related companies.[24] Inherent risk connected with finance companies appears to center on the valuation of the collectibility of loans. In the cases of Mill Factors Corporations and Atlantic Acceptance

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[24]See Appendix A, Mill Factors Corporation, Case No. 20; Blair & Co., Case No. 24; Atlantic Acceptance Corporation, Case No. 13; Valley Commercial Corporation (an affiliate of Continental Vending Machine Company), Case No. 7; and Seaboard Commercial Corporation, Case No. 1.

Corporation, the auditors were accused of negligence in their work associated with the collectibility of outstanding loans. Had the nature of the client's business been fully understood by the auditors, it would appear that a great deal more evidence would have been needed concerning the realizable value of the loan portfolio.

The BarChris case is another example where failure to give adequate consideration to the nature of the client's business proved disastrous to the individual auditors involved and their firm. Perhaps the most obvious fact in the case was that the bowling industry as a whole was in a period of decline and substantially over-built. Also, percentage-of-completion accounting presents some real problems for auditors. Special care must be taken to see that profits are not over-stated by merely increasing the percentage-of-completion figure on the books. Substantial time should have been spent to ensure that the stage of completion was stated properly, especially in light of the fact that the industry was in a general decline and the company was short of cash. In addition, the company also was in need of supplementary financing.

Before it is possible to design a realistic audit program, or test the effectiveness of internal control, it is first necessary to know and understand the risks associated with a given business enterprise.

Every public accountant will be called upon to audit many different types of business enterprises. Auditing, "if it is to attain maximum utility, must be taken into consideration, and be tailored to fit, the individual characteristics of specific types of businesses."[25]

The *CPA Handbook* discusses the special auditing problems that one might encounter in the following types of businesses:

(1) Advertising Agencies
(2) Motion Picture Theatres
(3) Construction
(4) Motor Carriers
(5) Investment Companies
(6) Retail Department Stores
(7) Newspapers
(8) Public Utilities
(9) Real Estate Firms
(10) Securities Brokers
(11) Petroleum
 (a) Producers
 (b) Refiners
 (c) Distributors[26]

It goes on to say that "in some businesses the complexities, trade practices and procedures are such that some knowledge of them by the auditor is essential as a basis for exercise of professional judgement as to the nature and scope of the audit procedures required."[27] This would indicate that failure to consider the problems associated with a given client's business and the risks involved enables auditors to assess what audit approach should be taken.

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[25] American Institute of Accountants, *CPA Handbook*, *Volume 2*, edited by Robert L. Kane, Jr. (New York, 1956), Chapter 20, p. 1.

[26] *Ibid.*

[27] *Ibid.*, p. 8.

The Reputation and Stability of Client's Management

The reputation and stability of client's management are really two factors combined, for simplicity, into one. During the course of this discussion, some effort will be made to separate the two aspects of this factor. The contention is that when an audit team is dealing with management that is highly reputable, honest and straight-forward, then relative risk is considerably lower than dealing with a management group not possessing these characteristics. Related to this point is another contention that stability, in terms of tenure, of the management group may also lower the auditors' relative risk, as they are more familiar with the people with whom they must deal. The opposite of these contentions would be that the auditors' relative risk would be high if management were considered dishonest or disreputable, or if there was a continual turnover in key personnel from year to year. A more refined examination of these contentions will follow in the general discussion of this factor.

Mautz and Sharaf pose as one of their basic postulates of auditing that there is "no necessary conflict of interest between auditor and management."[28] They state earlier in their work that

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[28] R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (Menasha, Wisconsin, 1961), p. 44.

> Postulates are assumptions that do not lend themselves to direct verification. The propositions deduced from the postulates of a given system, however, can be directly verified, and such verification bears evidence of the truth of the postulates themselves.[29]

This "postulate" would appear to be invalid as far as the practicing accountant is concerned. However, this is not to say that the opposite of the postulate is true, e. g., that there is a necessary conflict of interest between auditor and management. By rejecting this notion as a "postulate," it is meant that the validity of the statement is subject to direct verification. In fact, it should be the auditors' responsibility to determine the validity of the statement. For where a conflict of interest is present, the relative risk of the auditor is increased.

It seems extremely surprising that the auditing and accounting literature have very little to say about the consideration of the reputability and stability of a client's management, while the literature in finance devotes a great deal of time to the subject. It also seems somewhat paradoxical that the financial analysts, examining a company for investment purposes, should be so concerned with this factor while the auditor, who relies a great deal upon the representations of management, has paid very little explicit attention to the same factor.

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[29] Ibid.

An evaluation of the reputation and stability of a client's management would appear to be the starting point in the consideration of any audit engagement. The public accounting firm must decide at the outset whether it wishes to be associated with the people who run the company, not the company itself. The decision reached concerning the association may have a great influence upon the degree of risk associated with the audit. After a prospective client has been referred to an auditing firm, for one reason or another, it then becomes the auditors' responsibility to make certain inquiries regarding the principals, directors and key managerial personnel to determine if they should associate with this group.

From the literature, it seems obvious that the most direct inquiries are made to reputable bankers and lawyers who have had dealings with the prospective client.[30] However, "reliance on intimate personal acquaintances is not a substitute for professional care."[31] This statement indicates that something beyond the routine inquiries to intimate acquaintances is necessary for the auditor to fulfill his obligation to use professional care.

Reference was never made in the auditing and accounting literature to the comments of the Securities and Exchange

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[30] See American Institute of Accountants, CPA Handbook, Volume 2, edited by Robert L. Kane, Jr. (New York, 1956), Chapter 13.

[31] *Ibid.*, p. 9.

Commission concerning the investigation of a prospective or established client's management. As one of the pronouncements stemming from the McKesson & Robbins scandal of the late 1930's, the Commission stated,

> The facts of this case suggest that for new and unknown clients some independent investigation should be made of the company and of its principal officers prior to undertaking the work. Such inquiry should provide valuable background for interpreting conditions revealed during the audit or, in extreme cases, might lead to a refusal of the engagement.[32]

In connection with the point of client investigation, the Commission continued by stating that, "furthermore, an examination of this kind should not, in our opinion, exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted."[33] From the above comments, it can be construed that if the auditors fail to make an "independent investigation" of all responsible individuals within a prospective client's organization, they could be charged with negligence in the performance of their duties. One might also construe the term "independent investigation" to mean the gathering of substantive facts upon which the auditors could base their opinion. The Commission, in these statements, made it obvious that they were referring not only to an investigation

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[32]Commerce Clearing House, SEC Accounting Series Release No. 19, "In the Matter of McKesson & Robbins, Inc." (December 5, 1940), p. 3042.

[33]Ibid., p. 3045.

of the company, but also an investigation of the people who operate the company. The Commission was speaking directly on the investigation of the reputation of the principals of the business. For in the course of the hearings, it was brought out that the President of McKesson & Robbins had been previously convicted of commerical frauds. He had been aided in the perpetration of these frauds by his three brothers who were later to become officers of McKesson & Robbins.[34] One would hope that, if the auditors had been aware of the reputations of the principal officers of the Company, the engagement would probably have been refused.

An effectively operating system of internal control can give some assurance to the auditors that material misstatements of accounts by employees of the business will be minimized. However, the principals of an organization are above the system of internal control. They are the individuals who institute the system.

What assurance does the auditing team have that material misstatements or misrepresentations by the principals of an organization will be minimized? As one outspoken practitioner has stated,

> The auditor's greatest risk of being involved with misleading financial statements is likely to stem from high-level fraud rather than from insufficient auditing procedures. By this, I mean deliberate and clever concealment of facts from

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[34] Ibid., p. 3040.

> the auditor or misrepresentations to him by top management. Such deceit can be extremely difficult, if not impossible to uncover. Most highly publicized scandals result from this type of fraud.[35]

In an effort to minimize such possibilities, the auditors must undertake an explicit evaluation of the reputation and stability of client's management. While there is some evaluation carried on by all of the "Big Eight" firms, it is questionable as to whether this investigation is as thorough as it should be.

Had in-depth evaluations of client's management been conducted, several of the legal and disciplinary actions outlined in Appendix A might have been avoided. As an example, the judge in the BarChris case stated that neither of the principals of the company were equipped to handle financial matters, and that both were men of limited education and managerial capabilities. Certainly this should have had some bearing on the audit approach. While not briefed in Appendix A, the "Great Salad Oil Swindle" is another example where the auditors failed to take into consideration the reputation of the principal officer of Allied Crude Vegetable Oil Refining Corporation. The man, Tino de Angelis, had previously been convicted of commercial fraud charges, and through the aid of American Express Company, started a swindle that cost American

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[35]American Institute of Certified Public Accountants, Corporate Financial Reporting: Conflicts and Challenges, edited by John C. Burton (New York, 1969), p. 250.

Express some \$90,000,000.[36] While no legal action was brought against the auditing firm, having their name associated with the "swindle" probably caused as much damage to their reputation as a lawsuit would have caused.

The efforts by the management of Liberty Equities to "dress up" their balance sheet and income statement speak loudly enough of their reputation.[37] The arrangement by the chairman of Blair and Company to bolster the financial position of the company by lending \$2,000,000 in securities that were withdrawn as soon as additional loans were arranged cast some doubt upon the honesty of this individual.[38] The general counsel of Mill Factors openly accused the company of poor and inept management of their commercial loan portfolio.[39] The president of Westec Corporation, through bogus dealings with relatives and fictitious subsidiaries, caused the filing of stock fraud and conspiracy charges.[40] The honesty and reputation of these individuals should have been seriously questioned by the auditors. The management of Belock Instrument Corporation was openly conspiring to

[36]Kenneth F. Byrd, "Accountancy and the Onslaught of Case Law in North America," The Accountant, CLVII (July 8, 1967), 34-41.

[37]See Appendix A, Case No. 25.

[38]Ibid., Case No. 24.

[39]Ibid., Case No. 20.

[40]Ibid., Case No. 17.

defraud the Federal Government.[41] The founder and president of San Francisco National Bank was convicted of violations of Federal banking laws and misappropriation of bank funds.[42] The president of Continental Vending Machine Corporation was deliberately draining off funds of the company for his own personal use.[43]

In all of these cases, it was not the employees, who are controlled to a certain extent by the checks and balances of a good system of internal control, who were charged with committing some civil or criminal wrong; rather, it was the principals and management of the companies. Certainly one may argue that these are merely isolated cases and represent only a small fraction of all the companies audited each year. However, FBI statistics show that in the banking industry, 27.3 per cent of all defalcations and misappropriations are carried out by persons at the managerial level or higher (it is not intended to infer that these statistics apply to all industries).[44] In addition, in many of the above cases, a careful evaluation of management by the auditors may have prevented the situation from occurring in the first place.

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[41] *Ibid.*, Case No. 16.

[42] See Appendix A, Case No. 12.

[43] *Ibid.*, Case No. 7.

[44] Milton M. Brocker, "Auditing Problems Relating to the Review of Internal Control," *The Journal of Accountancy*, CXXVII (February, 1969), 78.

Yet another point is that it would probably not take too many of these "isolated" cases to seriously damage the reputation of an accounting firm.

The stability of the management team is the second part of this factor which needs to be considered by the auditor. When auditors deal from year to year with the same managerial personnel, they are better able to assess each individual's strengths and weaknesses, as well as his honesty and integrity. This helps the auditor in his estimation of the relative risk of the entire engagement. If, on the other hand, there is a continual turnover in key managerial personnel, the auditors are dealing each year with an unknown quantity. Evaluations are apt to be inaccurate as so little is known about the new personnel. It should not be inferred from the above generalizations that stability in management is in every case a virtue. The auditor must also recognize the factor of "management obsolescence" in connection with the management under review.

The question remaining is: How should the auditors determine their evaluation of the reputation and stability of a client's management? Naturally, the results of the evaluation will have a significant effect upon their determination of the risk assigned to the audit engagement.

The literature in all fields of business is filled with books and articles about the "management audit." In capsule

form, the management audit is a system designed to tell the investigator the quality of management based upon certain criteria. In the field of auditing, it has specifically been suggested by many writers that the audit opinion should contain some statement about the quality of management and the type of job they have done in the past year. This may or may not happen in the future; but it does not solve the practitioners' immediate problem of how to evaluate management for its own information. Today the auditor is confined to merely expressing an opinion on the fairness of presentation of the financial statements.

> He can't report to [the stockholders] whatever he likes or tell them whatever he wants. He may know that the president is ruining the company by his bad judgement, or that he is spending most of the time of the golf course instead of taking care of the company's affairs. Though the shareholders who appointed him would presumably be most interested to know this--and maybe should know about it--the auditor cannot tell them so.[45]

However, reporting information to outsiders is quite another story from gathering information for your own use. As a starting point in a meaningful evaluation of client's management, the auditor should select the best attributes of the management audit. This information should be used in formulating a decision concerning the relationship between client's management and the relative risk. This process

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[45] J. R. M. Wilson, "Responsibilities of Auditors and Company Directors," The Journal of Accountancy, CXXI (May, 1966), 59.

may involve asking "embarrassing" questions of the principals and prying into areas that have not been explored before. If the evaluation is to have substance, all pertinent data should be gathered.

It may be best to break the evaluation into two broad categories: (1) Personal qualities of the key executives of a company, and (2) managerial capabilities of the key executives. From these two broad categories, questions can be designed to aid the auditor in evaluating the client's management. Several possible questions have been gleaned from various sources in the literature and are presented below:[46]

(1) Current organization and staffing
(2) Past accomplishments in the industry
(3) Plans for the future
(4) Who are the men on the top management team
(5) How old are they
(6) Have there been any noticeable problems in the team
    (a) in-fighting
    (b) individual personal problems
    (c) job dissatisfaction
(7) What is the background of each
    (a) educational
    (b) business
    (c) personal
(8) Have there been any key shifts in personnel or assignments in the past year
(9) What plans have been made for management succession in key personnel.

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[46] For a sample of some of the above questions, see Fred V. Malek, "Assessment of Management Quality," Business Horizons, XI (April, 1968), 23-28; Douglas A. Hayes, "The Evaluation of Management," Financial Analysts Journal, XXIV (July-August, 1968), 39-42; Phillip H. Dutter, "Quality of Management," Financial Analysts Journal, XXV (March-April, 1969), 105-108.

The list of possible questions could be continued for several pages; however, the point is that the auditor must gain an intimate knowledge of the company's top management team. More will be said about an explicit evaluation method in the concluding chapter of this study. It is only through an objective evaluation of the reputation and stability of client's management that the auditor can hope to make any rational decision about the degree of risk involved in the engagement.

Independence of the Auditor

The question of independence is one that has plagued the auditing profession for many years. The function of the auditor is to act as an independent party whose objective evaluation of the financial conditions of a company can be relied upon by outsiders. The presumption is that the auditor is independent. Before going further into the relationship between audit independence and relative risk, it is necessary to determine what constitutes an independent accountant in the eyes of professional societies and governmental regulatory agencies.

Rule 1.01 of the Code of Professional Ethics of the American Institute of Certified Public Accountants states the following regarding independence:

> Neither a member or associate, nor a firm of which [the auditor] is a partner shall express an

> opinion on financial statements of any enterprise unless he and his firm are in fact independent with respect to such enterprise.
>
> Independence is not susceptible of precise definition, but is an expression of the professional integrity of the individual. A member or associate, before expressing his opinion on financial statements, has the responsibility of assessing his relationship with an enterprise to determine whether, in the circumstances, he might expect his opinion to be considered independent, objective and unbiased by one who had knowledge of all the facts.[47]

Further in the Rule, the Institute states two instances that would cause an accountant to be considered not independent:

> (a) During the period of his professional engagement or at the time of expressing his opinion, had, or was committed to acquire, any direct financial interest or material indirect financial interest in the enterprise, or
>
> (b) During the period of his professional engagement, at the time of expressing his opinion, or during the period covered by the financial statements, was connected with the enterprise as a promoter, underwriter, voting trustee, director, officer or key employee.[48]

In the concluding comments of the Rule, the Institute states that the above two examples are not meant to be all-inclusive. In other words, there are many other situations that would cause an auditor to be considered not independent. It should also be noted that Statement on Auditing Procedures No. 42 requires the auditors to disclaim an opinion when they are not in fact independent.

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[47] Independent Auditing Standards, edited by J. C. Ray (New York, 1964), pp. 44-45.

[48] Ibid., p. 45.

The Securities and Exchange Commission has also formulated a definition (Rule 2.01(b) of Regulation S-X) of what constitutes an independent accountant for purposes of practicing before the Commission. It should be noted that their definition preceded that of the AICPA and is as follows:

> The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person he has, or had during the period of report, any direct financial interest or any material indirect financial interest, or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer or employee.[49]

Neither of these rules are of much help in aiding the practicing accountant in "assessing his relationship with an enterprise." For independence is, in fact, a state of mind or an attitude maintained by the practitioner. The rules that have been promulgated cite only obvious situations that might cause the auditor to lack independence.

The majority of the discussions of independence in the literature do not revolve around the various rules of independence presented above. Rather, the literature begins where the (quite inadequate) rules end.

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[49]Ibid., p. 45. It is interesting to note that the language in both definitions is almost identical and that the SEC definition preceded the AICPA definition by several years. Furthermore, the SEC goes on to indicate at least fifty-three examples where accountants were considered not independent. See Thomas G. Higgins, "The Need for a New Rule of Independence," The Journal of Accountancy, CXI (January, 1961), 37-42.

Several authors have suggested that independence is in reality a twofold concept; independence in fact and independence in appearance. The following quotation accurately describes the twofold nature of independence:

> It is most important that the CPA shall refuse consciously to subordinate his judgement to that of others [independence in fact], but also that he avoid relationships which would be likely to warp his judgement even subconsciously in reporting whether or not the financial statements he has audited are in his opinion fairly presented [independence in appearance]. Independence in this sense means avoidance of situations which would tend to impair objectivity or create personal bias which would influence delicate judgements.[50]

The auditor, therefore, has a twofold responsibility in connection with independence. He must be able to display to his peers and the general public that he did in fact act independently in the discharge of his duty and further that he did nothing to give the appearance that he did not act independently.

The results of failure to fulfill these responsibilities can be disastrous for the individual practitioner, the firm with whom he is associated, and the accounting profession in general. For failure to act in an independent and professional manner, the practitioner may have his certification revoked, be denied permission to practice before the Securities and Exchange Commission and be sued in court by clients

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[50] John L. Carey and William O. Doherty, _Ethical Standards of the Accounting Profession_ (New York, 1966), p. 9.

for third parties. Any of these actions would certainly damage the reputation of the individual and his firm. "The importance of maintaining the auditor's independence cannot be overemphasized. Unless accountants are entirely objective in their work . . . the profession will lose stature."[51]

When the auditors compromise their independence, the risk associated with that audit engagement increases. The Wall Street Journal accused the auditors of failure to exercise enough independent judgement in their audit of Liberty Equities Corporation.[52] While the case is still in the pre-trial stages, one of the central issues may well be the fact that the auditors failed to give the appearance of acting independently. In the case of Revenue Properties, there is little doubt that the partner in charge of the audit was in fact not independent, as he held a financial interest in one of the subsidiaries of the company.[53] Likewise, in the case of Franklin Supply, the partner in charge of the audit was in obvious violation of the rules of both the AICPA and the SEC, for he served on the board of directors of a client.[54] One of the primary issues in the Continental Vending Case was that the auditors failed to give the

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[51]Ira N. Frisbee, "How Personal Attributes of the Auditor Affect the Application of Auditing Standards," The Journal of Accountancy, XXCIX (February, 1950), 123.

[52]See Appendix A, Case No. 25.

[53]Ibid., Case No. 21. [54]Ibid., Case No. 19.

appearance of independence by their drafting of the nebulous Footnote to the financial statements.[55] Both of the disciplinary proceedings involving Thomascolor and Seaboard Commercial were instituted because, in the opinion of the SEC, the auditors failed to act in a professional manner.[56] In both proceedings, the question of the exercise of independent judgement was brought up by the Commission.

There is a real dilemma which the auditors must face in assessing their relationship with a client where independence is concerned. "The relationship between the client and the auditor puts the accountant at a disadvantage. The auditor is supposed to make an impartial report to . . . the public. But it is not the public that hires and fires him; it is the client."[57] The client can always get another auditor, but the auditor may not be able to replace a lost client. It would appear extremely difficult to maintain an absolutely independent attitude in light of these circumstances.

> There is always a natural desire to want to please a client, but moving too far in this direction may easily result in giving approval to statements which are actually misleading. Such a mishap is almost certain to be followed by a loss of reputation and eventually by a loss of clients.[58]

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[55] Ibid., Case No. 7. [56] Ibid., Cases No. 1 and 3.

[57] "Why Accountants Need to Tell a Fuller Story," Business Week, MMLXCII (February 6, 1971), 86.

[58] Howard Stettler, Auditing Principles (Englewood Cliffs, N. J., 1956), p. 57.

Even given the precariousness of this situation, the auditors must maintain their independence, for to do otherwise would be to increase the relative risk they will assume.

A suggested approach aimed toward helping the practitioner assess his independence on any given audit engagement is presented in the concluding chapter of this study.

Client's System of Internal Control

The generally accepted definition of internal control was given in Chapter I, and there is no need to repeat it. However, for purposes of this study, it is necessary to expand on the context of internal control. Internal control should be viewed in its broadest context, not merely confined to a system of internal accounting checks. The definition should be thought of as including such activities as budget preparation techniques, the utilization of budgeted information, the disposition and utilization of various management reports, employee training procedures, the effectiveness of delegated authority to the various functional areas of the company, etc. When one thinks about internal control in this very broad sense, new information is obtained that may prove helpful in the risk evaluation process.

An elaborate system of accounting controls does not assure an efficient system of internal control. New progress toward a more meaningful evaluation of internal controls can be made, once one adopts a broader concept of the system. The emphasis should be on administrative controls as well as accounting controls.

The relationship between internal control evaluation and the evidence gathering function has received extensive attention in the accounting and auditing literature. However, there is very little discussion of the relationship between internal control and the auditors' relative risk.

Before discussing this latter relationship, it is necessary to explain the process used by auditors to evaluate internal control. All of the large public accounting firms have developed some type of internal control questionnaire that serves as the base for the evaluation. The auditor in charge of the evaluation gathers information about the various controls in effect in each major accounting area (cash, accounts receivables, etc.). After information has been gathered in a particular area, he formulates some judgement about the relative strength or weakness of the controls in that area. This process is continued until all major accounting areas are covered. At the conclusion of the evaluation, he may be required to assess the general strength or weakness of the entire system of controls.

Based upon his conclusions in each area and for the system as a whole, he then has some information that can be used to determine the scope of the audit procedures to be followed in each area.

Where internal control is strong, this means that there is a low probability that there will be material misstatements

in the account.[59] Where internal control is weak, there is a higher probability of misstatements in the accounts. Weak internal control requires the auditor to extend his procedures to gather more evidence and convince himself of the fact that material misstatements do not exist.

The above discussion has a direct bearing on the relative risk of the audit engagement. A strong system of internal control tends to lower the relative risk involved. The auditor knows that the probability of material misstatements is low and the conventional audit procedures should be adequate to confirm this belief. On the other hand, a weak system of internal control tends to increase the relative risk.

The auditor is aware of the weakness in the system and must therefore plan procedures to uncover any misstatements if they are present. He is called upon to make certain decisions in order to ascertain which procedures are needed. It could be that conventional procedures would not reveal the misstatement that may exist. In any event, the auditor knows that the probability of material misstatements is greater where a weak system of internal control is suspected, and his risk of attesting to misleading financial statements is greater. As a generalization, it can be stated that the auditor's relative risk varies directly with the weakness of the client's system of internal control.

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[59]Even in the strongest system of internal control, there is always the possibility of misstatement through collusive fraud or other schemes.

To verify the above comments, one can look to the San Francisco National Bank case where it was concluded that the bank's system of internal control was "unsatisfactory," and as the facts of the case indicate, there was material misstatement in some of the accounts of the bank.[60] Yale Express System offers another example of weak internal control. The internal control of this company was one of the factors that lead to the downfall of the company and a lawsuit against the auditors. The weak internal control at Yale lead to the misstatement of the cash account by some $438,000.[61] Meigs and Larson describe weak internal control as leading to a "high risk audit situation."[62] Stettler also agrees, as indicated by his statement that "Circumstances surrounding a situation will . . . . affect relative risk. The degree of internal control associated with the accounting and handling of an item is one such factor. . . ."[63]

Type of Financing Used by Client

The type of financing used by a client influences the risk of that company as well as the risk of the auditor. Perhaps the most obvious example of the relationship between

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[60]See Appendix A, Case No. 12.

[61]*Ibid.*, Case No. 8.

[62]Meigs and Larson, *op. cit.*

[63]Stettler, *op. cit.*

the types of financing and the auditor's relative risk is represented by securities that are publicly traded. The Securities and Exchange Commission requires that all such securities be registered before they can be sold to the public. As part of this process, the company must file audited financial information as well as other information in a registration statement and prospectus. The auditors involved in this process then become subject to all of the sections of the Securities Act of 1933 and the Securities Exchange Act of 1934. Both of these Acts impose severe penalties upon any party issuing false or misleading statements. The most relevant portions of the two Acts are Section 11(a) of the 1933 Act, and Section 10(b)-5 of the 1934 Act.[64]

The essence of these Sections provides that anyone who relied upon false or misleading information, or material

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[64]Section 11(a) of the Securities Act of 1933 reads as follows: If a registration statement contains "an untrue statement of a material fact or omitted to state a material fact required to be stated or necessary to make the statement therein not misleading, any person acquiring such securities . . . may . . . sue . . . (4) every accountant . . . with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him . . . . Section 10(b)-5 of the Securities Exchange Act of 1934 reads as follows: "It shall be unlawful for any person directly or indirectly by the use of any means . . . of interstate commerce. . . (b) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . ." It should be noted that Section 11(a) of the Securities Act of 1933 provides a specific civil remedy to the injured party, while Section 10(b)-5 of the Securities Exchange Act of 1934 does not. However, the courts have held that any person injured by the misstatement or omission does have a civil remedy under 10(b)-5.

facts that were omitted from a registration statement, may sue the accountants and others for damages suffered in the purchase of the securities.

In addition to the liability imposed upon auditors by these Sections of the Securities Acts of 1933 and 1934, the Securities and Exchange Commission may institute disciplinary proceedings under Rule 2.04 relating to independence, or Rule II(e) relating to failure to act in a professional manner. Generally, adverse findings under these rules result in suspension from practicing before the Commission.

By associating with a client whose stocks or bonds are publicly held, the auditor subjects himself to an entirely new set of liability rules and therefore increases his relative risk. If the client is a private concern, such as a partnership, or if the client is a closely held family corporation whose stock is not registered, the various rules of the Securities and Exchange Commission do not apply to the auditor. The majority of the cases and disciplinary actions outlined in Appendix A were related to alleged violations of the Securities Acts of 1933 and 1934. The auditors' relative risk is increased every time he is dealing with a publicly held corporation.

When a client uses long-term bond financing, the auditor's relative risk might be increased. Most bond indentures contain certain restrictions upon the operations of the

company. If the bonds are mortgage bonds, the indenture agreements generally state that the company will keep the mortgaged property in good repair, that it cannot sell or dispose of the property without the permission of the bondholders, that it carry adequate insurance on the mortgaged property, that it cannot issue additional debt without the consent of the bondholders, that it maintain a certain current ratio, etc. Sometimes the restrictions are quite severe, while other times they may not really represent restrictions as far as the company is concerned. The point of this discussion is that should the company fail to comply with any of the restrictions, it would be technically in default on the bond issue. This means that the bondholders have the right to force the company to repay the bonds, usually with some penalty involved. In reality, however, the company can often get a waiver of default, which means the bondholders will take no action against them.

From the viewpoint of the auditors, this situation would present the necessity of their checking each audit to ascertain that the company is complying with all the indenture restrictions. If the company is in technical default on the issue, their opinion must await the waiver from the trustee. If no waiver is forthcoming, the company could be forced to declare bankruptcy.

The possibility of bankruptcy always exists when a company fails to meet the required restrictions. Norman O. Olson

has stated that "it appears, in most cases affecting auditors which have been publicized in recent years, the client went bankrupt or investors or creditors otherwise lost large sums of money."[65] Thus, where the possibility of bankruptcy exists, the possibility of adverse action against the auditors also exists, and the relative risk increases. To further amplify this point, Judge Elmore Whitehurst, a prominent District Bankruptcy Referee, has stated that one of the primary causes of business failure is the type of financing used by the company.[66] He concludes that in some cases businesses are underfinanced and therefore unable to continue what might have been a profitable operation. Judge Whitehurst also points out that many companies simply cannot meet their fixed debt payments and are forced by creditors into bankruptcy proceedings.

Another topic relating the term "relative risk" to the client's financing is that of leverage. Perhaps Graham and Dodd offer the best explanation of the function of leverage by a corporation.

> The presence of a substantial proportion of senior capital [debt and preferred], carrying a limited charge for interest or dividends, permits the relatively small common issue to benefit from the earnings of a much larger capital fund. Under

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[65] Norman O. Olson, "The Auditor in Legal Difficulty--What's the Answer?" The Journal of Accountancy, CXXIX (April, 1970), 42.

[66] Elmore Whitehurst, "How to Avoid Corporate Bankruptcy," Texas Bar Journal, XXXIV (February 22, 1971), 143-144.

> normal or average (emphasis added) conditions, the fund will earn more than the cost of the senior capital; hence, the return on common will be considerably above the rate on the entire capital.[67]

Leverage can be thought of as a technique of increasing the return to common stockholders and thus earnings per share.[68] Leverage works extremely well for some types of businesses; for others, it may prove to be disastrous. Leverage can work in situations where the business is reasonably certain of a fairly constant stream of earnings. That is to say, they are confident that the fixed debt obligations can be met. Where past experience has shown that a company's earnings stream has been unstable, a high degree of leverage can quickly lead to bankruptcy.

Baxter states that "a high degree of leverage increases the probability of bankruptcy and therefore increases the riskiness of the overall income stream."[69] This author goes on to say in his conclusions that "the risk of ruin (bankruptcy) thus becomes increasingly important as the degree of financial leverage increases."[70] Again, where there is risk

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[67]Benjamin Graham and others, Security Analysis (New York, 1962), p. 637.

[68]For purposes of this study, the works of Modigliani and Miller have not been considered. The reader should be aware that they refute the concept of leverage. For more detail regarding their theory, see F. Modigliani and M. H. Miller, "The Cost of Capital, Corporate Finance and the Theory of Investment," American Economic Review (June, 1958).

[69]Nevins D. Baxter, "Leverage, Risk of Ruin and Cost of Capital," Journal of Finance, XXII (September, 1967), 402.

[70]Ibid.

of bankruptcy, the auditors' relative risk is increased. The auditors must give special attention not only to the type of financing used by the client (debt and equity), but also to the variability of the client's income stream when assessing the risk involved in the audit engagement.

In addition to reporting to the Securities and Exchange Commission, the client may be required to report to any number of other governmental regulatory agencies, i.e., The Federal Power Commission, The Rural Electrification Agency, The Federal Communications Commission, etc. When audited financial statements are submitted to these agencies, the auditor can be held responsible for any misstatements or omissions. This further increases his relative risk.

A brief review of some of the cases and disciplinary actions in Appendix A will illustrate specific examples of the relationship between the client's type of financing and the relative risk of the audit engagement. Blair & Co. was required by certain governmental agencies to maintain a specified capital requirement.[71] The Company was in violation of these capital requirements at the time their financial statements were published. Failure to disclose this violation resulted in a lawsuit against the auditors and officers of the Company as well as the Company's directors. The required reporting to both the SEC and the Ontario

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[71]See Appendix A, Case No. 24.

Securities Commission ultimately lead to a lawsuit against the auditors of Revenue Properties.[72] Otis-McAllister specifically violated one of the requirements in their loan agreement with several banks. The banks charged that the auditors did not disclose this violation in the Annual Report of the company, nor did they notify the various banks involved.[73] The eventual downfall of Atlantic Acceptance was due largely to their inability to obtain additional short-term debt. The financing used by the company was quite different from that used by most finance companies.[74] The legal action against the auditors of Marrud, Inc. resulted from their failure to disclose certain restrictions in the loan agreement between Marrud and certain of its creditors.[75] BarChris' rather unique methods of financing sales put them in a constant cash strain position. Due to this strain, the company was unable to meet its interest payments on the debentures and was thereby forced into bankruptcy.[76] Failure to disclose the terms of the finance agreement between Brunswick Corporation and C. I. T. lead to a lawsuit against the company's auditor.[77]

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[72]*Ibid.*, Case No. 21.

[73]*Ibid.*, Case No. 15.

[74]*Ibid.*, Case No. 13.

[75]*Ibid.*, Case No. 9.

[76]*Ibid.*, Case No. 6.

[77]*Ibid.*, Case No. 5.

These cases amply illustrate the relationship between the client's type of financing and the relative risk of the audit engagement.

<u>Client's Rate of Growth</u>

Growth has become an extremely popular word in financial circles during the past twenty years. The use of this word has come to equate size with quality in the minds of many corporate executives, securities dealers and the investing public. <u>Fortune</u> regularly publishes a list of the 500 largest industrial corporations and has just recently begun to publish a list of the second 500 largest corporations. Growth is, as it should be, considered a sign of vitality in all companies. Growth may come about through internal expansion of an already existing company or through the merger or acquisition of one company by another. Most recently, the trend has been to grow through mergers and acquisitions. Rapid growth in either manner can cause severe problems for the management of the company as well as the accounting firm called upon to audit the company. This study is not concerned so much with the manner of growth by a company, rather with its rate of growth. The contention is that the client's rate of growth may influcnce the auditors' relative risk.

A company experiencing rapid growth may change its character drastically in a relatively short period of time. One cannot automatically assume that XYZ Corporation, 1972,

is basically the same company as XYZ Corporation, 1971. This is one problem that the auditors must recognize immediately. The company that they audited last year may be very different from the company they are to audit this year, even though the name is unchanged. Failure to recognize this fact and consequently to incorporate needed changes into the audit program, may prove unfortunate for the auditors. The audit program and procedures followed in the past may prove to be wholly inadequate in the current period. A mere "up-date" of the internal control questionnaire may be impossible, and a completely new evaluation of internal control may be in order.

While there are many factors that should be of concern to the auditor of a rapidly growing company, at least three factors deserve his utmost attention. One problem area that is likely to develop in a rapidly growing company is that of control and coordination. In referring to some of the problems of corporation growth, one author has stated, "control problems will be the handmaiden of the future . . . it will be a challenge to maintain the kind of cohesive group control that we had as a smaller company."[78] A rapidly growing company may easily out-grow its system of internal controls. What in the past may have proved to be a strong system may now have lapsed into weakness. Or even worse from the

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[78]James K. Braon, and others, "Company Growth: Mostly Planned But Sometimes Painful," The Conference Board Record,

auditors' viewpoint, a formerly weak system may now be a mere shambles. Even well-planned rapid growth may result in an obsolete or weakened system of internal control. The problem may compound itself if the growth was accomplished through mergers. Management must mesh the two or more systems of control into one. If this is not done, the auditors may be faced with many different systems of control, some of which are relatively strong and others that are considerably weaker. "As the two (or more) groups attempt to define appropriate operating policies and procedures for the joint enterprise, they may continually find themselves in strong disagreement."[79] The result may be a system of controls that are unsatisfactory to all parties involved, including the auditors.

The second major problem area faced by a rapidly growing company is that of people. This problem is at least two dimensional: "shortages of qualified personnel, especially managers . . .; and the necessity for executives to measure up to the greater demands upon them in a growth environment."[80] This problem is directly related to the reputation and stability of client's management that has been discussed previously in this paper. Since auditors must rely heavily upon

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[79]Richard E. Davis, "Compatibility in Corporate Marriages," Harvard Business Review, XLVI (July-August, 1968), 93.

[80]Braon, op. cit., p. 9.

management for information and evidence gathered in the course of the audit, dealing with persons who are not fully qualified for their position casts doubt on the validity of the information gathered from them.

A final problem in a growth company that should be considered by the auditors is that of adequate financing. Rapid growth is usually coupled with the expansion of office and production facilities. Unless the company is in an extremely strong financial position, this means a need for additional capital. The availability and cost of additional capital can often mean the difference between success or failure in any attempt to expand.

> Companies that cannot internally generate the funds needed for expansion will be plagued with two principal difficulties: (1) shortage of both debt and equity funds, and (2) a likely increase in the cost of money. These difficulties . . . will affect not only company capital investment plans, but also the demand for company products.[81]

The auditors' primary concern should be with the adequacy of the financial planning function of the company. Most financing needs can be anticipated. It is when little attention is given to the future capital requirements that serious problems may develop.

All of these factors must be considered in-depth by the auditors when evaluating the relative risk associated with auditing a rapidly growing company. The lawsuits filed

[81] Ibid., p. 10.

against public accountants tend to reinforce this statement. For example, many of the problems of Westec were probably the direct result of the president's extreme concern with growth. At the 1966 annual meeting of the stockholders, he stated that the company could *only* grow internally at the rate of fifty per cent per year, and that acquisitions would be undertaken to increase this rate.[82] Statements like this probably lead to a policy of growth at any price; and the price was a high one indeed. The case of Yale Express is an excellent example of how the three problems mentioned above proved to be the downfall of the company.[83] The merger between Yale Express and Republic Carloading proved to be a total disaster. Both companies had weak systems of internal control, and the two managements were unable to mesh the systems together. The president of Yale did not understand the operations of a freight forwarder, and after the merger, open hostility broke out between the two managements. Throughout the merger negotiations, the price that Republic demanded kept increasing. The final purchase price placed a real burden upon Yale Express, and severely weakened its financial position. Mill Factors offers another example of the dangers inherent in rapid growth.[84] The commercial loan

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[82]See Appendix A, Case No. 17.

[83]*Ibid.*, Case No. 8.

[84]*Ibid.*, Case No. 20.

division of the company (which represented a diversification from its main factoring operations) was the fastest growing division in the company. Unfortunately, the portfolio manager was not highly qualified for the position and demonstrated this by the granting of several highly speculative loans. As a result of his actions, the company was forced into bankruptcy. BarChris Construction Company offers an example of where rapid growth and the inability to obtain adequate financing led to the eventual collapse of the company.

Longevity of the Audit Engagement

The longevity of the relationship between the auditors and their client can influence relative risk in several different ways. In one respect, a long relationship can often lead to an attitude of complacency on the part of the auditors. This attitude may cause them to overlook important aspects of the audit that could result in some type of adverse action against the firm. In this sense, the longevity of the relationship may tend to increase the auditors' relative risk.

> From the client's viewpoint, it is argued that the continuation of a relationship with a single accounting firm prevents the auditor from taking a fresh look at the company's financial and accounting practices and planning. Despite rotation of staff, the partner in charge of an account generally remains on the job for a number of years, and he may become committed to existing corporate procedures. Even if this is not the case, he may develop a frame of reference similar to his client's, and his ability to

> supply an outside approach becomes limited. Finally, it has been suggested that long relationships cause the auditor to take the client for granted, and thus reduce the level of accounting services offered.[85]

In their study of auditor changes, Burton and Roberts offer some of the remarks that they received concerning why a company decided to change auditors. The remarks reinforce the general statement made above. For example, one corporate official responded as follows:

> Changes in our internal, financial and accounting organization were made in the period and it seemed appropriate to make a change in auditors at that time. This change was not made as a result of any unfavorable performance . . . but rather to emphasize the company's desire to review and update all of its accounting practices.[86]

Another response sighted in the study is as follows:

> We feel that X's staff members assigned to our audit had let the audit become somewhat perfunctory after several years and were not making enough constructive suggestions and criticism. This was particularly true in relation to the fee which we felt excessive for the audit performed.[87]

Explicit recognition of the problems associated with a long auditor-client relationship has been given by a number of prominent practitioners. An outspoken partner in one of the nation's leading accounting firms has stated that, "to the extent possible provision should be made for some rotation

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[85]John C. Burton and William Roberts, "A Study of Auditor Changes," The Journal of Accountancy, CXXIII (April, 1967), 31.

[86]Ibid., p. 33.

[87]Ibid., p. 34.

of personnel on jobs. There is a danger that when one is assigned to an engagement too long, he may lose a little of his objectivity."[88] While the statement is couched in rather cautious language, the meaning is clear and tends to confirm the relationship between longevity of association and relative risk.

Another prominent practitioner has related the problems of longevity to the legal actions pending against some public accounting firms. In response to the notion that rotation of personnel within an accounting firm, in effect, provides a fresh look at the company each year, he states that,

> Several cases have come to public attention where audited statements were criticized and new auditors brought in. The new auditors found it necessary to make tremendous adjustments in the figures of the preceding years.[89]

In his remarks the author could be referring to any one of a number of cases. The author may be referring to the case involving the valuation of Thor Power Tool's inventory by two different accounting firms; or the Atlas Plywood case, where the change in auditors resulted in the company reporting a $10,000,000 loss compared with $400,000 income in the prior year before the change; or possibly the Franklin

[88] Olson, <u>op. cit.</u>, p. 41.

[89] J. S. Seidman, "Letters to the Journal," <u>The Journal of Accountancy</u>, CXXIII (May, 1967), 31.

Supply case, where a change in auditors revealed a material misstatement of the company's inventory.[90]

It is also possible to consider the longevity of the relationship between auditor and client from another viewpoint. As the auditors and the client work together over a number of years, the auditors gain additional and intimate knowledge of the client's operations. The auditors are also in a better position to evaluate the strength or weakness of the client's management. As they gain more knowledge and experience with a given client, the audit can be conducted in a much more efficient manner. The auditors know where the weaknesses are and what procedures are called for to satisfy themselves that the financial statements are fairly presented. Viewed in this light, the longevity of the engagement would tend to lower the auditors' relative risk.

No matter how one views longevity of the engagement, the conclusion is the same; it does influence the relative risk of the audit engagement.

Summary

The review of the literature has demonstrated that the hypothesized factors do affect the degree of risk associated with a given audit engagement. The accounting and auditing literature lends support to the relative risk relationship;

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[90] See Appendix A, Cases No. 10, 4 and 19.

however, the facts developed from the review of legal and disciplinary actions offer the most conclusive evidence that the factors influence risk. All of the factors that could conceivably influence risk were not discussed in this chapter. However, it has been shown that the hypothesized factors are included in the set of all possible factors. Through further research in this area, the relative risk relationship can be broadened to incorporate new factors. The most important source offacts concerning relative risk will come from increased knowledge of the facts surrounding legal and disciplinary actions brought against public accountants. There is a need to continually up-date the available information in this area.

The review of the literature has also shown the interdependence of many of the factors discussed. In several of the cases cited, a combination of the factors led to the actions against the public accountants. The relationships between the various factors will become evident as more sophisticated studies of relative risk are undertaken.

CHAPTER III

INTERVIEW RESULTS

Scope and Format of Interviews

The personal interview format was designed to cover two main areas of interest: first, the extent to which the risk evaluation process has been rationalized and formalized by members of the eight leading national accounting firms; second, the reactions of practitioners to the relative risk relationship developed in Chapter II.

Interviews were first conducted in the Dallas-Fort Worth area to obtain responses from local office representatives. Local offices are responsible for instituting the policies and procedures established by the home offices. The relationship between local offices and the home office is in a state of flux today. Generally, local offices are losing more authority to the national organization, whereas at one time they were treated as autonomous entities. This situation varies from firm to firm and from office to office.

Approximately one month after the Dallas-Fort Worth interviews were concluded, interviews were conducted with home office representatives of the firms. There was no variation in the questions between local and home office representatives.

In all, approximately 5,000 miles were travelled to complete the interviews with 18 individuals. The respondents included nine local representatives and nine home office representatives of the eight national accounting firms. Of the eighteen respondents, sixteen were partners in their firms and two were managers.

For the most part, local respondents aided in identifying the home office representatives who were directly interested in the problem of risk evaluation. In general, the home office respondents had devoted much more time to the problem area than the local interviewees. In one particular case, the home office interviewee was charged with the responsibility of identifying the factors which cause an audit to be a high risk engagement.

All individuals interviewed at the home offices of the firms would by no means be classified as "average" practitioners. They were all men who held high positions with their firms. As a group, they could be characterized as highly intelligent, articulate and had an exceptional grasp of the problem area under discussion. Many of them have written articles for various accounting journals and were active in the American Institute of Certified Public Accountants and the American Accounting Association.

The interview format which is reproduced in Appendix B dealt with an area that was considered "sensitive" by the

interviewees; they all requested that neither they nor their firms be identified in the paper. With this assurance, the interviewees were helpful and candid in their responses.

The respondents were unaware of the specific questions but were informed of the general areas to be covered in the course of the interview. As the interview format shows, rather general questions were used to start the interview and then proceeded to the more specific questions as it progressed. Notes were taken during each interview, and immediately afterward a brief summary of the interview was written to insure accuracy.

The results of the interviews are presented below. A synopsis of the question is followed by a generalized answer based on all responses received. Specific responses of interest follow the generalizations.

Interview Results--Risk Evaluation Efforts of the Eight Firms

(a) Given the definition of risk used in this study, can practitioners identify relatively high risk audits?

The responses to this question tended to be remarkably similar. All of the interviewees stated that companies with inexperienced and/or inept management were relatively high risk engagements. Interviewees from five of the eight firms identified companies whose stock was considered an "investment fad" or "glamor stock," such as rapidly growing conglomerates, to be high risk. The consensus of opinion was

that investor expectation generally exceeded the performance of these companies, which can lead to disappointment and in many cases loss of money. Another reason stated for the high risk associated with "glamor stock" companies was that management in such companies may become overly concerned with earnings per share and less concerned with orderly, economically sound growth. Interviewees from three firms stated that new companies or those in the promotional stage tend to be high risk audits. The reasons for the risk were that these companies usually experienced some difficulty in raising capital, and they also have a very high incidence of failure. Another reason given was that management of these companies was often inexperienced.

With regard to specific industries, interviewees from four firms named small finance and loan companies as high risk companies. They stated that lending in this industry was far less stable than banking operations; and as auditors, they were faced with the problem of appraising the collectability of loans outstanding. Interviewees from two firms included companies in the construction industry as high risk engagements. In addition to the accounting and auditing problems presented by the percentage-of-completion method of profit recognition, the interviewees stated that the industry in general suffered from a lower business morality than most other industries.

Interviewees from three firms associated higher risk with companies that were in the process of registering with the Securities and Exchange Commission for the first time. They stated that the higher risk was due to their increased liability under the 1933 and 1934 Securities Acts. Two of these same three firms also named "purchase audits" as relatively high risk engagements. They stated that in the course of purchase negotiations, the audited financial statements were used to help establish the purchase price. If for some reason the information contained in the statements proved to be false or misleading, the auditor has a direct liability to the purchaser.

Interviewees from three firms mentioned companies on the verge of bankruptcy as representing higher risk to the auditor. The general opinion was that the company's receiver in bankruptcy or its major creditors look to any source to recover investments, and it is becoming more fashionable to blame the bankruptcy on poor accounting and the auditor.

The responses to this question clearly indicate that practitioners in the major accounting firms are able to identify certain audit engagements as relatively high risk engagements. While there was certainly no unanimous agreement as to which types of audits were high risk, there were several industries and types of companies identified as high risk. The importance of the responses received is that

practitioners are able to associate degrees of risk with various types of audits.

(b) Prior to an audit engagement, is relative risk explicitly considered by your firm?

None of the firms included in this study had formalized procedures or guidelines for the evaluation of the degree of risk associated with a given audit engagement.

(c) How is relative risk evaluated by your firm?

Interviewees from all of the eight firms stated that risk was considered informally. Generally, the evaluation of risk was made in connection with their new client investigation procedures.

New client investigation procedures involve an investigation of the client's principals and a financial history of the company. The following sources are generally used in the course of the investigation:

(1) Reputable attorneys who represent or have had dealings with the principals or the company.

(2) Bankers and underwriters who have had dealings with the principals of the company.

(3) Dun & Bradstreet and/or Retail Credit Association.

Additional sources of information that may be used include the prospective client's former auditor and a brief history and current financial situation of the company, including trends in earnings per share and the stock price. It is

common professional courtesy for the new auditors to contact former auditors and discuss, in general terms, the strengths and weaknesses of the company. Historical information is available in most standard reference material, i.e., _Moody's Manual_, _Standard & Poor's_, etc.

However, one of the firms included in the survey went beyond the standard practices and employed a private investigating agency in cases where the prospective client was relatively unknown. This was the only firm that indicated any variation from the investigation procedures mentioned above.

The new client investigation procedures were for the most part formalized by the firms. However, in three cases the procedures were merely suggested guidelines rather than step-by-step procedures. Even where the procedures have been formalized, the depth of the investigation is usually left to the individual partner who is to be in charge of the audit. Therefore, if the prospective client is known, an investigation may be very cursory. As a result, not all procedures for new client investigation are followed in every case by the firm. A great deal is left to the "professional judgement" or experience of the individual practitioner.

The results of the new client investigation are handled differently by the firms. In three cases, the partner in charge of the investigation is required to write a report

stating the facts that have been gathered and his conclusion as to accepting or rejecting the prospective client. The report is reviewed, usually by other partners in the office, before a final decision is made. In the remaining firms, the results are usually discussed with other partners in the office before the final decision is made.

For repeat audit engagements, there are no formalized procedures for investigation or risk evaluation. Factors discussed which may lead to a re-investigation included a massive turnover in key management of a client or a client's continual fighting about accounting treatments suggested by the auditors. The decision to start a re-investigation is left to the partner in charge of the engagement. No one interviewed was able to identify a particular instance which involved a re-investigation.

A majority of the firms included in the survey did maintain a system for reporting "difficult" clients. If a client presents a "difficult" situation for the audit partner, a report of the facts is written at the end of the engagement. This report is then reviewed before a decision is made concerning future audit work with the particular client. However, there are no explicit guidelines for determining what constitutes a "difficult" client.

All persons interviewed stated that information gathered in the course of a new client investigation was adequate for

the purpose of determining the desirability of accepting or rejecting the client. However, it was pointed out that reliable information could be obtained from lawyers and bankers only on a personal contact basis. These two groups would be extremely reluctant to report anything negative about a prospective client unless they knew their remarks would be kept in the strictest confidence. Their reports are usually obtained on an "off the record" basis. It then becomes part of the practitioners' work to cultivate these personal relationships; for without them, new client investigation would prove of little value.

Dun & Bradstreet presents a neutral report on an individual while Retail Credit tends to produce what can be termed "negative" reports about an individual. For the most part, Retail Credit reports on what the client has failed to do, rather than what he has accomplished. The reports are only capable of identifying the individual or company which is experiencing very obvious problems.

Three of the individuals interviewed expressed some reservations about the quality of the information gathered from the above sources. Yet they concluded it was adequate for their purposes.

One of the firms included in the survey classified all of its clients as either "risk" or "non-risk" engagements. However, it was stated that the criteria used to determine a

"risk" engagement are somewhat unrealistic. For example, any companies traded on the New York or American Stock Exchanges were classified as "risk" engagements. By using these criteria, AT&T or General Motors are considered "risk" engagements while Atlantic Acceptance or Belock Instruments would be considered "non-risk" engagements.[1] An interviewee from this firm stated that by applying the established criteria, every major audit engagement was probably classified as a risk engagement. In effect, the criteria do not establish the degree of risk associated with the engagement.

(d) What factors influence a decision to refuse either a new or repeat engagement?

The following were the most common reasons stated for refusing an audit engagement:

(1) Inability to pay audit fee--generally indicating the company is too small for a national accounting firm.

(2) Lack of confidence in management.

(3) Continuing disputes over accounting principles.

(4) Nature of client's business considered high risk.

Four of the interviewees stated that repeat engagements were seldom refused. They stated that following the ability to pay fees, the only reason for refusing a repeat engagement was a basic disagreement over accounting principles that could not be reconciled.

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[1] See Appendix A, Cases No. 13 and 16.

All interviewees agreed that new engagements were refused much more often than repeat engagements. The primary reason stated for refusing a new engagement was the size or potential size of the proposed client's operations. If the company was small and had little possibility for future growth, it was generally referred to a local or regional public accounting firm. The reasons for not accepting the engagement were related to the problems that often develop in a small company (lack of adequate financing, general competence of management, inability to pay audit fee, etc.)

(e) What do you consider a good working definition of internal control?

There was no general agreement among the interviewees as to a working definition of internal control. However, interviewees within the same firm gave similar answers to the question. Five of the eight firms in the survey have adopted a much narrower definition of internal control than that given by the AICPA in _Accounting Research Study No. 7_.[2]

Interviewees from the five firms stated that internal control was primarily a system of checks and procedures that would prevent or deter errors or irregularities in the accounting records. While not specifically stated by the interviewees, fraud detection or prevention would seem to be the end result of a good system of internal control.

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[2]Paul Grady, _Inventory of Generally Accepted Accounting Principles for Business Enterprises_ (New York, 1965).

Interviewees from the remaining three firms gave a somewhat broader definition of internal control that was more in line with the AICPA definition. These three definitions em-emphasized the importance of people in the entire business system. Their definitions included statements about the efficiency with which the company was operated, the use made of financial statements by management, and the importance of management and administrative controls.

(f) Does your firm use a standard questionnaire for the evaluation of internal control, or does the questionnaire vary from audit to audit?

All firms included in the survey used a standard questionnaire for the evaluation of internal control. By "standard questionnaire" it is meant some sort of pre-printed list of questions designed to detect weaknesses and strengths in the client's system of internal control. A flexible questionnaire would be one that is specifically designed for a particular audit engagement.

Internal control questionnaires were obtained from four of the eight firms interviewed. The remaining four firms stated that it was their policy not to distribute any material of this nature to persons outside of the firm.

Three of the four questionnaires obtained required "yes-no" responses to the various questions. The other questionnaire required a written report on the client's system of internal control and offered certain questions as guides

for gathering relevant information. Most of the questions in this questionnaire could not be answered by a "yes-no" response. The "yes-no" response questionnaires provided space for the client's answer to the question and also space for the auditor's answer to the same question. This serves as a check to make certain that client responses are correct.

All of the questionnaires obtained were divided into sections which corresponded to various balance sheet accounts. For example, one of the questionnaires had the following sections:

(1) General
(2) Cash
(3) Marketable Securities and Investments
(4) Sales and Accounts Receivables
(5) Notes Receivable
(6) Inventories
(7) Property, Plant and Equipment
(8) Prepaid Expenses
(9) Intangible Assets
(10) Notes Payable
(11) Purchases and Accounts Payable
(12) Accrued Liabilities
(13) Deferred Charges
(14) Capital Stock
(15) Other Revenue

All of the questionnaires were remarkably similar in their section titles. The length of the questionnaires varied from as few as ten pages to as many as 150 pages.

Within each section of the questionnaire, there were numerous detailed questions relating to how the client accounted for and controlled each particular asset, liability, revenue or expense. In every case the section dealing with

cash had the greatest number of questions to be answered. The "yes-no" response questionnaires were designed in such a manner that a "no" answer to any of the detailed questions indicated a weakness in the internal control system. For example, a question relating to Cash Disbursements stated "Are the supporting documents impressed with a 'paid' stamp or other mark so as to prevent their use for duplicate payment?" If the answer to the question is "no," the weakness discovered is that invoices and other supporting documents could be re-submitted for duplicate payment. The questionnaire that required a written report contained a similar question, but it was phrased in broader terms. It asked if any notation of payment was made on supporting data and how, when, and by whom it was made.

Six of the firms interviewed have developed different questionnaires for several different types of business operations. The interviewees representing these firms stated that different industries present different types of auditing problems, and the questionnaires were developed to produce more meaningful audit programs. Several of the interviewees stated that the composition of the assets of companies in different industries required the development of different questionnaires. For example, it was pointed out that the primary assets of a public utility are plant, property and equipment, whereas a commercial bank would have substantial

monetary assets. The different types of industries had different systems of internal control due to the nature of their assets. To properly evaluate the system in a given industry, more explicit questionnaires were developed.

Within the six firms using different industry questionnaires, the number of questionnaires varied from a maximum of fourteen to a low of six. The average number of different industry questionnaires was eight. Generally, the larger the firm in terms of total revenue, the greater the number of different questionnaires. A list of different industry questionnaires common to all six of the firms includes:

(1) Commercial and Industrial
(2) Public Utilities
(3) Commercial Banks
(4) Savings and Loans
(5) Life Insurance
(6) Food Processing

Two of the firms use a single internal control questionnaire for all of the audit clients. One of these firms has just recently changed from the practice of using several different types of industry questionnaires. This firm has developed a rather complex questionnaire that is used to determine the scope of the audit work to be done. When a deficiency is found in the client's system of internal control, the questionnaire will refer the auditor to another listing which identifies the problems that can arise as a result of the deficiency and the extended audit procedures

required to compensate for the deficiency. This firm has combined the two required audit steps of evaluating internal control and relating the evaluation to the scope of the audit program.

(g) Who conducts the evaluation of a client's system of internal control?

All firms follow similar procedures in the evaluation of internal control. In most cases a senior accountant conducts the evaluation of internal control; i.e., he completes the internal control questionnaire. His work is reviewed by the managers and partner assigned to the audit. However, for extremely large engagements or complex new engagements, the manager may be required to perform the evaluation. His work is then reviewed by the engagement partner.

A senior accountant generally has from two to five years of public accounting experience, while a manager usually has from five to ten years of experience.

(h) Have the internal control questionnaires changed significantly in the last ten to fifteen years?

While all interviewees stated that the questionnaires have changed during this period of time, the reasons for the changes were quite different. Interviewees representing four of the firms stated that the growth in electronic data processing in industry caused the greatest changes in the internal control questionnaire. Two firms have developed a

supplementary questionnaire relating to the controls and procedures followed by a company's data processing department.

Interviewees from three firms related changes in the questionnaires to efforts to move away from the traditional "yes-no" response questionnaire. They indicated that the traditional questionnaires tended to make the evaluation somewhat mechanical and inhibited creative thinking about the client's system of internal control. However, as pointed out earlier, one of the major accounting firms has moved away from the broader types of questionnaires to a more sophisticated "yes-no" response questionnaire.

One interviewee stated that major changes in his firm's internal control questionnaires were due to the proliferation of multi-plant operations. He stated that operations of this nature created a situation in which there was less knowledge about the company at the very top of the hierarchy. This situation can lead to a lack of effective planning and control by the company leaders.

Interviewees from two firms stated that fee limitations have caused major changes in the internal control questionnaire. They stated that many clients have become more cost-conscious in recent years and fee pressures have forced the auditors to streamline many of their procedures. They pointed out that this did not mean that the quality of the work performed was lessened but that more efficient methods have been found to accomplish the same task.

(1) Does your firm maintain a working paper review committee? If so, what is its purpose and how does it function?

All eight firms have some type of working paper review committee. The review was, in all cases, felt to be a quality control operation of the firm.

In most cases, a review is conducted in each local office every one to three years. An outside reviewer, usually a partner from another office, selects at least one audit for each manager and/or partner in the office being reviewed. A formalized review program is used to evaluate the quality of the work performed during the course of the audit. At the conclusion of the review, meetings are held with the various managers and partners, as well as a general staff meeting, to discuss the findings of the reviewer.

It is also common practice for the reviewer to forward the results to the home office where they are compared with the results of previous reviews. If serious deficiencies in past reviews have not been corrected, the home office notifies the local office of needed changes in their audit procedures.

As in the case of internal control questionnaires, work paper review programs were obtained from four of the firms included in the survey. Where copies of the program could not be obtained, sufficient information was given to allow a general description of the program.

The typical review program included the following broad sections:

(1) Pre-planning of the audit engagement
(2) Adequacy of working paper documentation
(3) Adequacy of audit procedures and internal control evaluation
(4) Adequacy of review of work performed
(5) Quality of financial statements and report issued
(6) Areas for improvement.

Of the four programs obtained, three contained very broad questions relating to a particular area of the audit, and the fourth contained very detailed questions covering each of the audit areas. The three broad programs were short in length consisting of ten pages or less, while the detailed program contained approximately thirty pages of questions. The most effective method of demonstrating the differences in the types of review questions is to use an example from the broad program as contrasted with the detailed program.

In the area of adequate disclosure of financial information, the typical question from the broad programs asked if the reviewer thought the financial statements and related footnotes were adequate and necessary for fair presentation or whether they were desirable but not necessary. This can be contrasted with the following questions from the detailed program:

(l) Were adequate disclosures made in the following areas:
   (a) Surplus restrictions
   (b) Bond and loan agreements
   (c) Capital shares reserved for options, etc.
   (d) Involuntary liquidation value of preferred stock
   (e) Required by APB Opinions relating to leaves, pensions, dilutive effects of convertible securities, etc.
   (f) Commitments or contingencies.

The broad review programs merely serve as a guide for the reviewer. The effectiveness of the review depends upon the sincerity and diligence of the reviewer. There is very little documentation of the review steps he followed.

(j) What are the most common problem areas mentioned in the reports of the reviewers?

As most of the firms do not attempt to generalize on the basis of reports received, the interviewees were unable to identify common problem areas. However, four of the interviewees from home offices stated that failure to clear all questions raised in the course of the audit seemed to be a recurring problem. This would mean that in some cases opinions were issued regarding financial statements when there still remained some unanswered questions about various procedures or accounts. Two of the interviewees stated that this could be extremely embarrassing if the working papers were ever used as evidence in court.

Another problem area was that of proper documentation of audit work performed. It could well be that evidence had

been gathered relating to a certain area of the audit but that no documentation of the work was made in the working papers. Again, if the papers were under review, it would be impossible to determine if the work called for had actually been done.

A final problem area mentioned was that in some cases there was a lack of timely and adequate review of the audit work by seniors, managers, and partners assigned to the engagement.

(k) Has the primary source of growth of your firm in the last ten to fifteen years been internal or through mergers?

All interviewees characterized the growth of their firm during this period as internal growth. Four interviewees stated that mergers did play an important part in their firm's growth in the immediate post-World War II era, but recent growth has been primarily internal.

(l) How rapidly has your Management Services function grown in the last ten to fifteen years, and how extensive are your services today?

There was no discernible trend in the answers to this question. Two of the eight firms have placed limits on the types of management services work that they will undertake. The limitation imposed in both cases was that the work be directly related to accounting problems of the client. Interviewees from these two firms stressed the importance of an accounting firm staying within its realm of expertise.

The remaining six firms had no formal limitations on the type of services that they could perform. However, interviewees from three of the six firms stated that they had never engaged in marketing services.

The six firms that did not restrict their management services work did engage in a wide variety of activities. Most interviewees were reluctant to discuss the specific types of activities covered by their management services departments. However, when viewing all responses to this question, a range of services can be pieced together. For example, most of the firms are involved in executive search for their clients and other companies. Other areas that were mentioned were information systems procedures, work management, long-range planning, actuarial services, engineering studies, plant layout studies and psychological testing.

All but one of the interviewees were reluctant to give specific answers to questions concerning the rate of growth of the management services function of their firms. The general trend was that about fifteen to twenty years ago, the management services function began to grow much more rapidly than the audit function. This stage of rapid growth continued until about five to ten years ago and then began to slow down, so that today the rate of growth is about the same as the audit function. This general trend did not apply to one firm, which stated that the management

services function is still growing at a much more rapid rate than the rest of the firm. This firm also offered the widest range of services.

(m) Does your firm perform management services and audit services for a client at the same time?

All of the firms included in the survey have in the past and are presently performing both types of services for a client if desired. All interviewees pointed out that the management services and audit services are conducted by different staff personnel. Generally, the firm will have a partner in charge of the audit and a separate partner in charge of the management services. Each partner has his separate staff which reports directly to him, and he has final decision in his area of responsibility. However, in the majority of cases, the audit partner was also considered to be the overall client partner. That is to say, he has the final decision in all matters relating to the client. In this case, the management services partner would actually report to the audit partner. Where internal conflicts develop between the management services and the audit partners, the problem is generally referred to the home office for solution.

(n) Do you think it impairs the firm's independence when management services and audit services are carried on for the same client?

None of the interviewees thought independence was impaired when both activities were performed for the same client. As this response was easily predictable, the intention of the question was to obtain the reasons why practitioners thought that this situation posed no threat to independence.

The most common reason given in response to this question was that the function of the management services is to advise the client on alternative courses of action available, and not to make the decision as to which course the client should take. They do not participate in the decision-making process; therefore, they cannot be held responsible for the results of the decision. Another common reason stated was that no evidence exists to prove that independence was impaired by performing the two activities for a single client. Interviewees from four firms stated that by using different staffs to do the work, the auditors were able to retain their independence. Two interviewees stated that the management services function of their firm benefited the auditors in that more experts were employed by that firm, and that their knowledge and experience served as resources to the auditor.

Interview Results--The Relative Risk Relationship

Each factor in the relative risk relationship is treated as a separate question for purposes of reporting the results

of the interviews. A summarization of all responses is presented at the end of this chapter.

(a) Does the rate of growth of a client's operation influence the risk associated with an audit engagement?

Eight of the eighteen interviewees thought that the rate of growth of a client's operation influenced relative risk in all cases. Eight interviewees stated that it could be an influence depending upon the specific circumstances. Two respondents stated that a client's rate of growth had no influence on the relative risk of an audit engagement.

Those interviewees who thought that the rate of growth was a factor or could be a factor in the evaluation of relative risk gave a wide variety of reasons for their answers. Five interviewees mentioned that an emphasis on growth through mergers greatly influenced the auditor's risk. They thought that these companies were unable to handle a downturn in business activity, and the management tended to minimize the importance of proper administrative and accounting controls. It was pointed out that orderly internal growth, even rapid growth, presented much less of an auditing problem than growth through mergers and acquisitions. The consensus of the sixteen respondents was that the factor should be expanded to include not only the rate of growth, but also the client's method of growth. Three interviewees stated that an undue emphasis on earnings per share often results

in undesirable growth. It was also mentioned that lack of adequate growth can present problems to the auditors, as stockholders may become disenchanted with the company's management. An interviewee from the home office of one of the firms thought that the rate and method of growth could be a factor in risk evaluation, but also stated that the companies with rapid growth rates were the preferred clients of his firm. The only conclusion that can be drawn from this rather inconsistent response is that his firm is willing to assume the greater risk associated with rapid growth.

(b) Does the nature of a client's business operations influence the risk associated with an audit engagement?

Fifteen of the interviewees stated that the nature of the client's business did influence the relative risk of an audit engagement. Two interviewees thought that it could influence risk depending upon the circumstances, and one interviewee thought that it did not have an influence on risk evaluation.

The answers to this question were generally consistent with those of the question relating to the identification of high risk audit engagements. Most of the interviewees thought that high risk and low risk businesses could be identified, but that they lack knowledge in associating risk with the vast majority of businesses.

It is interesting to note that the interviewee who thought that the nature of a client's business did not

influence the auditor's relative risk identified four types of audits that he considered high risk. They included franchising operations, small and medium size finance companies, and promotional type operations.

Three of the interviewees associated the nature of a client's operations with the composition of assets and liabilities. They stated that certain types of assets and liabilities were more difficult to audit, and their presence influenced the auditor's risk.

(c) Does the type of financing used by a client influence risk associated with the audit engagement?

Thirteen of the interviewees thought that the client's financing influenced the relative risk of the auditors and five stated that it could influence the risk in certain circumstances.

Eight of the interviewees specifically mentioned the high risk associated with public offering and the problems that may result upon registration with the Securities and Exchange Commission. However, this is not as revealing as the fact that the remaining ten did not mention the registration process as a source of additional risk.

Two interviewees mentioned that the use of complex capital structures to "make" profits rather than earn them through operations was a source of additional risk to the auditor. Along this same line, one other interviewee

noted that the use of leverage to create earnings was a source of possible risk.

One interviewee stated that the real factor to be considered was not the type of financing used by the client, but rather the type of financing that would be available to the client in the future.

The consensus of all interviewees was that while the type of financing does influence the relative risk of the auditor, it is difficult to generalize beyond that point.

(d) Does the reputation and stability of a client's management influence the risk associated with the audit engagement?

All eighteen of the individuals interviewed shared the opinion that the reputation and stability of client's management influenced the relative risk of the auditors. All agreed that the reputation of management was the most important factor as far as risk was concerned. Most of the interviewees stated that if management were less than honest and straightforward with the auditors, problems would soon develop that could prove damaging to all parties concerned.

Two interviewees thought that stability of management could have some rather peculiar effects upon the auditor's relative risk. On the one hand, they recognized the importance of continuity of management as an important factor in lowering the risk. However, both individuals

pointed out that stability of management where the managers and principals were hopelessly out of date with respect to business practices could increase the risk to the auditors.

Most interviewees made some comment to the effect that it was not difficult to evaluate the reputation of a prospective client's management and principals and that adequate steps were taken to insure that all their clients had reputable management.

(e) Does the effectiveness of a client's system of internal control influence the risk associated with an audit engagement?

Sixteen interviewees thought that internal control was a factor that influenced risk in every audit engagement, and two interviewees stated that it was not a factor to be considered. However, the two "no" responses probably resulted from a failure to understand the question clearly. Both individuals that gave an answer of "no" to this question stated that the auditor could compensate for a weak system of internal control by expanding the audit program and gathering additional evidence. Of course, the reason for expanding the audit procedures is to compensate for the additional risk involved. Neither interviewee accepted this reason for expanding the audit procedures. Both maintained that procedures were expanded because of weak internal control, rather than higher risk. These two interviewees did not associate the client's system of internal control with the relative risk of the audit engagement.

The remaining sixteen interviewees all mentioned the American Institute of Certified Public Accountants' standards that required an evaluation of internal control to determine the extent of audit procedures. With only one exception, all interviewees made some comment about the ability of the auditor to compensate for a weak system of internal control by expanding audit procedures. The one exception was that internal control could be so weak as to make a company unauditable.

(f) Does the independence of the auditors influence the risk associated with an audit engagement?

Eight interviewees stated that independence influenced relative risk on all audit engagements, four stated it could influence risk in certain circumstances, and six stated that it did not influence the relative risk.

The group which thought independence was a factor in all engagements or could be a factor in certain circumstances gave several reasons for their answers. Three interviewees mentioned the problems that develop when an accounting firm becomes an advocate for a particular client's method of handling business transactions. Related to this response was the statement by two interviewees that certain accounting firms have become defenders of "liberal" accounting practices which tends to attract clients who would use these practices to improve their financial position. Three interviewees stated that independence became a factor every time the

auditors were placed in the position of choosing between alternative accounting treatments of the same transaction, where the alternatives were both generally acceptable. Two interviewees discussed the relationship between independence and the size of the accounting firm. Both felt that independence was more a problem of the smaller firms and did not present a real problem to the larger firms.

The typical interviewee who thought that independence was not a factor which influenced the auditor's relative risk cited the various steps that his firm had taken to insure that all members remained independent. This type of response is somewhat inconsistent in that the individual is merely describing procedures that the firm has taken to minimize the influence of independence as a risk factor. It would seem that a more logical response to the question would be one that recognizes independence as a well-known influence upon risk and that certain steps have been taken by the entire profession to reduce the influence caused by lack of independence. The fact remained that all these interviewees thought that there was no relationship between the auditor's independence and the relative risk of the engagement.

(g) For repeat engagements, does the longevity of the relationship between the auditor and client influence the relative risk?

Seven interviewees thought that the longevity of the audit engagement influenced the relative risk; seven thought

that it could influence the risk in certain circumstances, and four were of the opinion that it did not influence the relative risk.

At first, most interviewees thought that longevity of an audit engagement would automatically decrease the relative risk involved because of the increased knowledge of the client's operations and the greater experience gained by working with client's management. However, after some thought about the question, five interviewees stated that it could tend to increase the risk if the auditors became complacent about the engagement. Other interviewees agreed with this thought when questioned directly, but also indicated that some planned and unplanned steps were taken to prevent the audit staff from treating the engagement as routine. They pointed out that the audit staff assigned to a particular client is rarely the same from year to year. This is due in part to planned rotation of job assignments for relatively inexperienced staffmen and in part to the high turnover of personnel. Many interviewees stated that they favored a policy of rotation of all audit personnel over some period of years. However, as far as could be determined, none of the eight firms had a policy to force rotation of personnel at all levels in the audit hierarchy.

In discussing the problems of rotation of personnel, it was stated that clients generally preferred to have

continuity from the in-charge senior position up to the partner level. It was claimed that clients felt the audit would be carried out more efficiently if there was some continuity in personnel. One interviewee stated that fee limitations tended to inhibit rotation of personnel because staffmen with previous client experience could complete the audit in a shorter period of time, thus holding down the total audit fee.

One interviewee expressed the opinion that the longevity of the engagement and the auditor's feeling of independence were really one factor that should be combined. He stressed the importance of remaining independent over a long period of time and the difficulties the auditors face in continuing relationships.

Those interviewees who thought that longevity did not influence the relative risk generally followed their answers with the steps taken by their firm to eliminate the problems caused by a continuing engagement. As with the previous question, this does not seem to be a logical answer. If a firm encourages the rotation of audit personnel, this may be an effort to reduce the risk associated with continuing audit relationships.

(h) Are there any additional factors that you feel influence the relative risk of either a new or repeat engagement?

Six interviewees offered additional factors that they felt should be considered in the risk evaluation process.

Some of these could be incorporated into the factors presented above, but for purposes of reporting the interview results, all the suggested factors are presented.

Two interviewees stated that the list should be expanded to include management's emphasis on earnings per share. Both men expressed similar views in this area. Where management is overly concerned with earnings per share, auditors will have a difficult time in gaining approval to record any audit adjustment that would decrease this figure. Companies whose managements fall in this category will tend to adopt the most liberal accounting practices in order to "dress-up" net income. Both men felt it would be extremely difficult to obtain a true picture of management's feelings until the first audit was almost complete. However, one of the interviewees suggested that the auditors note the present accounting practices followed by the company as a sign of the emphasis on earnings per share.

A second additional factor was the long-range plans of the company. This interviewee stated that competent management usually had formulated goals and objectives for the company as a guide for future action. This same individual thought it important to know if the company was a public corporation or privately owned. He associated higher risk with the public corporation. It should be noted that this interviewee did not discuss this factor in connection with the type of financing used by a company.

One interviewee mentioned that the general experience with the client was an important factor when considering the risk associated with repeat engagements. When questioned as to how the evaluation of past experience could be conducted, he admitted that it would be extremely difficult. As an example of the difficulty in evaluation, he cited several instances where clients proved to be very stubborn, not in any effort to improve their financial positions, but rather because they had intelligent accounting personnel who were not easily swayed from their positions. These clients might well be classified as "difficult" when in fact they are merely highly competent individuals.

Two interviewees mentioned the general financial condition of the company as yet another possible factor. In discussing this factor, both men indicated that since most lawsuits developed out of companies which had become bankrupt, the auditors should pay special attention to the financial condition of all clients. One of the interviewees indicated that rapid swings in profits and losses might be one sign of a company in financial difficulty. No suggestions were offered as to how the auditor might identify, with a high degree of certainty, a financially distressed company.

A final factor suggested by one interviewee was the use of questionable methods of growth by a client. This interviewee thought that growth for its own sake was often an

undesirable management practice, and that all growth should be based on sound business reasoning. He specifically criticized the conglomerate practices of growth through mergers and pooling-of-interest accounting as a method of increasing earnings per share.

(i) In view of the importance placed upon the reputation and stability of client's management as a factor in risk evaluation, does your firm have any formalized procedures for appraising this factor?

Representation from seven of the eight firms stated that they had no formalized procedures for evaluating this particular factor. The interviewee from one firm, which employs a private detective agency to investigate new clients, stated that information gathered by the agency, along with information from other sources, allowed them to evaluate the factor directly. A copy of the investigation procedures could not be obtained from this firm, as they were understandably considered highly confidential. It should be noted that the procedures are new and have yet to be proved in practice. The discussion of the procedures revealed that the detective agency was to gather background information on the principal owners and/or employees of a prospective client and any other information that might prove valuable in deciding whether to accept or reject the engagement.

Interviewees from the seven firms having no formal procedures for appraising the reputation of a client's management

referred to the new client investigation procedures as their source of information. A review of these procedures was presented above.

(j) If you were attempting to evaluate the risk associated with an audit engagement and information was available relating to the factors discussed, how would you rate the importance of knowing the information?

To refresh the interviewee on all the factors discussed, he was given a rating sheet as shown in Appendix B, page 232. He was asked to rate the factors in order of importance by placing a "1" next to the factor he considered to be most important, a "2" for the next factor, and so on. In addition, he was asked to delete any factors that he considered to be of no use in the risk evaluation process and to add any factors he considered to be important. Where the interviewee added additional factors, he was asked to rate those factors in order of importance. The interviewees were asked to rate only those factors which were external to the operations of a public accounting firm. The internal factors, i.e., independence and longevity of engagement, were therefore not included in the list of risk factors given to the interviewee.

Table I below shows the results of the ratings. The reader should note that the total ratings for any one factor may not equal the total number of interviewees. This is due to the fact that a factor may be deleted from the list by a

TABLE I

RANKING OF RELATIVE RISK FACTORS BY RESPONDENTS

Factor	Number Ranking Factor As					
	1st	2nd	3rd	4th	5th	6th
Reputation and stability of client's management	14	2	1			
Client's system of internal control	1	5	2	1	2	2
Rate of growth of client's business		1		5	6	1
Nature of client's business	2	6	4	2		
Type of financing used by client	1		5	4	3	
Other Factors:						
Financial condition of client				1		
Client's long-range plans			1			
Emphasis of client's management on earnings per share					1	1
Publicly held corporation		1				
Past experience with client			1			
Client's method of growth				1		

respondent. In three cases, interviewees were able to rate only a few factors and stated that the importance of the remaining factors varied depending upon specific circumstances.

To summarize the results of the rankings, a weighted average rank was determined for all factors that were rated by ten or more interviewees. The results of the weighting process are given below in Table II.

TABLE II

WEIGHTED AVERAGE RANK OF RISK FACTORS

Factor	Weighted Average Rank
Reputation and stability of client's management	1.2
Nature of client's business	2.4
Client's system of internal control	3.3
Type of financing used by client	3.6
Rate of growth of client's business	4.5

As this table shows, the reputation and stability of client's management was considered the most important factor in evaluating the relative risk of an audit engagement. It is also significant that fourteen of the respondents rated this factor as the most important. Internal control, which is considered in great detail in most standard auditing

textbooks, rated behind the nature of the client's business as a factor in the risk evaluation process. The first and second factors are very rarely considered explicitly in the auditing literature.

There were some inconsistencies in the answers given during the discussion of the individual risk factors and the ranking of the factors. For example, fifteen interviewees thought that the nature of a client's business operations influenced the relative risk of all audit engagements, and two interviewees thought it could influence the risk; however, only fourteen interviewees ranked the factor as being important to a process of risk evaluation. Much of this inconsistency is explained by the three interviewees mentioned above. These individuals selected only what they considered to be the most important factor and explained that it was impossible to rank the remaining factors as the ranking would depend upon particular circumstances. If the responses of these three individuals are eliminated from the ranking, the remaining rankings are consistent with the responses given during the discussion of the individual factors. If an interviewee stated that a particular factor did not influence risk of an engagement, he consistently deleted that factor from the ranking.

Summary of Findings

A brief summary of the major findings of the personal interviews is presented below:

1. Practitioners with the eight major accounting firms were able to identify certain types of relatively "high risk" audit engagements. The major concern of most individuals interviewed was associating a degree of risk with the vast majority of audits that cannot be termed either "high" or "low" risk audits. The high risk engagements mentioned were identified by industry rather than individual companies. Therefore, as a first step in the risk evaluation process, it may be desirable to identify as many high risk industries as possible.

2. The process of risk evaluation by the eight accounting firms is informal. Information that may have a bearing upon risk evaluation is gathered from a variety of sources. These sources include new client investigation procedures, working paper review reports, internal control questionnaires, past experience with the client, and recent legal actions against public accountants. The actual evaluation of the risk involved in a given audit engagement is, for the most part, left to the "professional judgement" of the individual partner or manager in charge of the audit. At best, this type of risk evaluation is incomplete.

3. The working definition of internal control is much narrower than the definitions stated in the literature. The broader definition of the AICPA forces the auditor to examine more of the company's operations than the definition given

by most practitioners in the survey. The limitation on the scope of a definition of internal control could inhibit the formalization of the risk evaluation process.

4. All firms used a standard type of questionnaire for the evaluation of a client's system of internal control. However, a majority of the firms have developed several different questionnaires for different types of business operations. There is an explicit recognition of the variation in accounting and auditing problems between companies in different industries. This reinforces the thought that the nature of a client's business operations influences the relative risk of an audit. The recognition of individual differences between industries and between companies within an industry is another important first step in the refinement of a risk evaluation process.

5. While the last ten to fifteen years have seen a vast change in the types of business organizations and means of conducting business, internal control questionnaires have not changed significantly.

6. All firms conduct simultaneous audits and management services for a client if desired. A majority of the practitioners in this survey thought that there was no conflict of interest in conducting these activities.

7. The reaction to the relative risk relationship is presented in Table III. Of the reactions of those interviewees

TABLE III

REACTIONS TO THE RELATIVE RISK FACTORS

Factor	Influences Risk	Could Influence Risk	Does Not Influence Risk
Nature of client's business operations	15	2	1
Type of financing used by client	13	5	0
Reputation and stability of client's management	18	0	0
Client's rate of growth	8	8	2
Client's system of internal control	16	0	2
Independence of auditor	8	4	6
Longevity of engagement	7	7	4

who thought the factor did influence the degree of risk and those who thought it could influence risk in certain circumstances, a vast majority agree that the relative risk relationship has some practical considerations.

This chapter presents the facts that were gathered during the course of the interviews. The following chapter will combine both these facts and those gathered from the review of the literature. By combining the theoretical and the practical, conclusions can be drawn about the nature of the relative risk relationship. The following chapter presents

these conclusions and develops a tentative program for the explicit evaluation of relative risk.

CHAPTER IV

SUMMARY AND CONCLUSIONS

Summary

Through interviews with prominent practitioners in the "Big Eight" accounting firms, the hypothesis of this study was confirmed: There is a process of risk evaluation conducted prior to an audit engagement; however, the evaluation is an implicit process. Among the firms interviewed, there are no formal procedures for evaluating relative risk. The evaluation relies heavily upon the "professional judgement" of each individual practitioner.

It was anticipated that the risk evaluation process would be labeled "informal" by the interviewees; therefore, the interview format contained a series of questions designed to discover how the practitioners gather evidence which allows them to assess the relative risk of an engagement. There is a great deal of information available to the astute practitioner that would aid him in his estimation of relative risk.

All firms included in the interview have new client investigation procedures. These procedures usually consist of discussions with close personal contacts of the practitioner, such as bank executives, lawyers and underwriters. The procedures also include a Dun & Bradstreet credit investigation,

and in some rare instances, a Retail Credit investigation. If the prospective client had another auditing firm previously, the new firm will generally (but not in all cases) contact the outgoing auditors and discuss the client's financial situation and any problems that have developed in the course of their audits. The outgoing firm may allow the new firm to review their recent audit work papers. At this point, the practitioners have gathered some historical information about the company and the people who run it.

Another source of evidence that can be used in the risk evaluation process is the information learned after the client's system of internal control has been evaluated. A weak system reflects directly upon the management of the company. It alerts the auditors to possible problems they may encounter in the audit process. It was learned, however, that all accounting firms interviewed utilize a standard questionnaire for the evaluation of internal control. Some writers have claimed that the standard questionnaire, generally requiring a "yes-no" type response on the part of the examiner, makes the evaluation somewhat sterile and inhibits creativity on the part of the examiner. To the extent that these accusations are true, the evaluation of internal control does not yield all of the potential information needed. Of the four internal control questionnaires gathered during the interviews, all were standardized and three required "yes-no" responses to the questions. It is also of interest that the majority

of the practitioners interviewed had a rather narrow concept of internal control, thus limiting the potential information that might be gathered during an internal control evaluation. Regardless of the limitations, the fact remains that a certain amount of information is gathered during the evaluation of internal control that enables the practitioner to better estimate the relative risk involved.

A further source of data available for the estimation of relative risk comes from the firms' working paper review program. All firms interviewed have such a program, which is designed to detect deficiencies and strengths in the audit procedures used on a particular engagement. The real problem with such a program is that the review takes place after the audit has been completed, and therefore can only help the practitioner on future engagements. Deficiencies in the evidence gathering function have often led to lawsuits and other adverse actions against the firm. When the deficiencies are known, steps can be taken to correct them in the future. The real value of the working paper review program is that, if effective, it may help to identify areas of high exposure that can be minimized in the future.

There are some serious problems that tend to limit the effectiveness of the working paper review program in some firms. From an examination of the four copies of the review programs gathered during the interviews, it is obvious that

some firms treat the program with a much higher regard than others. The working paper review program can be of some value if applied seriously by the reviewer and considered in-depth by the office under investigation. There is some doubt that a five- to ten-page program questionnaire can thoroughly review the deficiencies and strengths of an office's working papers. On the other hand, the one firm that used an extremely intensive review program was probably able to derive some real benefit from the program. Another problem with the working paper review programs was that there was very little effort by the home offices of each firm to generalize on the findings of all the reviews conducted during a given period. If common problem areas were identified and communicated to the local office practitioners, this would appear to enhance the benefits of the entire program.

Additional information that may prove helpful to the practitioner in his efforts to judge the relative risk is that information gained from the firm's past experience with specific types of clients. Certain firms tend to specialize in certain audit areas, i.e., public utilities, hospitals, transportation, etc. All persons interviewed were able to identify what they considered to be "high risk" audit engagements. It can be assumed that their responses were based to some extent upon past experience that they, or some member of their firm, had with that particular type of client. In

response to the question of identifying "high risk" engagements, many of the interviewees reinforced the relative risk factors that were to be discussed later in the interview. For example, several persons identified high risk with "inexperienced and/or inept management," companies such as rapidly growing conglomerates and companies that had difficult financial problems or were in the process of registering with the Securities and Exchange Commission. They were able to associate a degree of risk with certain types of businesses, such as finance and loan companies, construction companies, and companies involved in merger and acquisition agreements.

Closely associated with the information obtained through past experience is the information derived from their review of recent litigation against public accounting firms. While all interviewees were reluctant to discuss specifics (even when their firm was not involved in the legal action), as a group they displayed an amazing knowledge of most of the lawsuits outlined in Appendix A. The information gathered from a study of these cases will aid the alert practitioner in estimating the risk of a given engagement. However, it should be mentioned that the persons interviewed in the home offices of the eight firms probably had a more complete knowledge of the litigation than the local practitioner. These were men of exceptional skill and intelligence, who had in some cases devoted a great deal of effort to the problem of minimizing audit risk.

One accounting firm that displayed some innovation in collecting information for the risk evaluation process has gone to the practice of hiring a private investigating agency to gather information on the background of the prospective client and the principals who operate the business. This would seem to offer a great source of information that is now not available to the other "Big Eight" firms. Objections to this practice were voiced by almost all of the other practitioners interviewed. The main objection was that it would be offensive to the client. A thought that bears some consideration is that the public accountants' function is to serve the general public directly, and the client only indirectly (through suggestions as to how to improve their accounting and reporting system).

A final point of some disappointment (although the response to the question was easily predictable) was that not one interviewee thought that the auditors' independence was impaired when management services and audits were performed for a client at the same time. These responses were received even in light of the glaring facts surrounding the Yale Express System case.[1] Most interviewees stated they do not make management decisions but merely identify alternatives for management. It should be pointed out that decision-making is a process, and the selection of alternatives is an important part in that process.

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[1]See Appendix A, Case No. 8.

Therefore, it would appear that the audit firm involved in providing management services is very much involved in the decision-making process. Several respondents stated that there was no evidence that independence was impaired when both types of services are performed for a single client. It is suggested that these respondents carefully read the judge's opinion in the preliminary actions of Fisher v. Kletz (the Yale Express System action). Failure to associate the rendering of audit and management services to the same client with independence, and therefore relative risk could prove unfortunate in the future.

Conclusions

As a result of the review of the literature and the personal interviews conducted, it was learned that the relative risk relationship has theoretical as well as practical validity. As shown in Chapter II, the relative risk relationship can be derived from the literature, and Chapter III has shown that the majority of respondents agree that the factors identified influence the risk of an audit engagement. Table III in Chapter III shows the reactions of the practitioners to the various relative risk factors.

Several interviewees expressed the opinion that the process of risk evaluation should be formalized to the extent possible. At least two firms are now in the process of formalizing their procedures. In practice today, the risk

evaluation process is incomplete and highly unstructured. Many of the factors that practitioners agree should be explicitly recognized, are not now being considered by them. As a starting point in an effort to formalize the risk evaluation process, a program has been developed and is presented below. This program has been developed after careful consideration of the facts gathered from the literature and the information contributed by the interviewees. It is hoped that this program can be modified and improved to the point where practitioners feel it will be of benefit to the entire audit process.

Relative Risk Evaluation Program

The objective of this program is to help you to determine the relative risk associated with this audit engagement. Your conclusions reached concerning the risk involved will have a direct bearing on the type of audit procedures to be used, and the quantity and quality of audit evidence that we must gather. Auditors, just as any other businessmen, are risk takers. We can never hope to find a riskless engagement. However, if you conclude that the relative risk associated with this engagement is unacceptable, it may be necessary to refuse the engagement. This program is not designed to cover all of the possible factors that could influence the audit risk, therefore, you are responsible for collecting any additional information that may influence the relative risk of this engagement.

A. Name of Client:

(1) Give a brief description of the nature of the client's business.

(2) Obtain client's recent financial statements and related footnotes.
   (a) Review the statements for any unusual items. Pay particular attention to the composition of the client's assets and liabilities.

(b) Where does the client rank, in terms of size, in its industry?

(3) What has been the firm's experience with other clients in the same business?
(a) List other clients.
(b) Briefly describe any auditing, accounting or tax problems, if any, we have had with these clients.

(4) How long has the client been in business?
(a) What do statistics show to be the incidence of failure in this line of business?

(5) Contact prior auditors, if any, and company officials to determine if client has been involved in any litigation that involved the prior auditors. Give consideration to any litigation that might have involved the auditors.

(6) Have there been any lawsuits or disciplinary actions against auditors resulting from the audits of companies in the same business?
(a) Briefly outline the facts surrounding the actions.

B. List the names and addresses of the principals of the client (President, Vice President, etc.).

(1) Obtain background information for each individual listed, including:
(a) Age
(b) Length of service with each company employed
(c) All previous business experience (be sure all time periods are accounted for in the listing)
(d) Educational background
(e) Compensation
(f) Time devoted to business (if not 100 per cent, is this individual employed elsewhere)
(g) Major stock ownership in companies other than client
(h) Criminal records of any kind.

(2) Through your personal contacts in business, inquire as to the personal life and habits of each individual.
(a) If this is not possible, employ Retail Credit Association or some other agency to make such inquiries.
(b) Briefly outline the results of the inquiries.

(3) Through personal interviews with key personnel, determine their awareness of current business trends and practices.
(a) Ask each individual to evaluate the management team of the client.

(4) Throughout the process of learning more about client's management, note any instance where you believe an individual has been less than candid and honest.

C. If this is a repeat engagement, list all personnel that worked on the audit for the past five years. (If we have not been associated with the client for five years, this list should be from date of first audit to present)

(1) If we have done special audit work, such as SEC work, make the same listing as above.

(2) Review all suggestions made to management for each year we have had audit responsibility.
(a) Note if suggested improvements have been implemented by management of client.
(b) Are there new and original suggestions each year?

(3) List all client criticism of audit conduct and personnel that we have received.

(4) Has the client expressed any desire to change auditors?
(a) If yes, what are the reasons given by management?

D. List the client's major sources and type of financing.

(1) Is the company publicly owned?
(a) Do we have the responsibility for reporting to various regulatory agencies?
(b) List the regulatory agencies to which the client must report.
(c) Has the client experienced any past difficulty in reporting to the agencies?

(2) Is the client's financing compatible with the financing in the rest of the industry?
(a) Debt to equity?
(b) Rates paid for debt (bonds and preferred)? If not, explain significant variations.
(c) Who is in charge of financial planning? What type of financial forecasts are made?

(3) Has the client experienced any difficulty in obtaining adequate financing, at a reasonable rate, in the past years? If yes, explain the circumstances.

(4) Is the company highly leveraged in relation to the rest of the industry?
   (a) For the last five years, calculate the ratio of cash flow to total fixed charges (bonds and preferred)
   (b) Does the ratio indicate a safe margin in all years?

E. Calculate the client's rate of growth in the past five years to ten years in terms of total assets, net sales and net income.

(1) Has the client's system of internal controls been up-dated to keep pace with its growth?

(2) Has the growth been largely internal, or through mergers and acquisitions?
   (a) Will there be any consolidated subsidiaries that are audited by another firm?
   (b) List all unconsolidated affiliated companies, the nature of their business and their relationship to the client.

(3) Has the client experienced any difficulty in hiring key personnel to keep pace with the growth?
   (a) Has the rate of growth of management personnel kept pace with the general rate of growth of the client?

F. Concerning our evaluation of internal control:

(1) Would you classify the client's system as poor, adequate or strong?

(2) What are the primary weaknesses in internal control?
   (a) Can we compensate for these weaknesses through extending our procedures, or might it be necessary to issue a low-grade opinion?
   (b) If the system is poor, would it prevent us from auditing the company at a reasonable fee?
   (c) Have we discussed our evaluation of internal control with client's management? Briefly comment on their reactions.

G. Audit Independence--

As the audit progresses, you must continually monitor your independence in relation to the client. It is assumed that no violation of the AICPA or SEC Rules of Independence will occur. We, as a firm, demand three types of independence in connection with our audit work: (1) programing independence; (2) investigative independence; (3) reporting independence. This should be clearly discussed with the client before the audit begins. During the audit you are to note and fully advise everyone connected with the audit of any violations of the independence requirements set out below:

(1) Programing Independence
   (a) Freedom from managerial interferences or friction intended to eliminate, specify, or modify any portion of the audit.
   (b) Freedom from interference with or an uncooperative attitude respecting the application of selected procedures.
   (c) Freedom from any outside attempts to subject the audit work to review other than that provided for in the audit process.

(2) Investigative Independence
   (a) Direct and free access to all company books, records, officers and employees and other sources of information.
   (b) Active co-operation from managerial personnel during the course of the audit examination.
   (c) Freedom from any managerial attempt to assign or specify the activities to be examined.
   (d) Freedom from personal interest or relationships leading to exclusion or limitation of the examination of any activity.

(3) Reporting Independence
   (a) Freedom from any feeling of loyalty or obligation to modify the impact of reported facts on any party.
   (b) Avoidance of the practice of excluding significant matters from the formal report in favor of their inclusion in an informal report of any kind.
   (c) Avoidance of intentional or unintentional use of ambiguous language in the statement of facts.

(d) Freedom from any attempt to overrule the auditor's judgment as to appropriate content of the audit report.[2]

(4) Are we performing any services for the client in addition to the audit, such as management services of any kind?

(a) Discuss in detail any conflicts that resulted from our dual responsibilities.

(b) What steps were taken to resolve the conflict?

(c) Did the conflict in any way affect the independence of our audit work. Consider the impact on all three types of independence listed above.

Much of the Risk Evaluation Program would have to be completed by the partner assigned to the client as the information would be considered highly confidential. After the program has been completed, a meeting of several partners should be held, and the important facts discovered should be discussed in depth. After the discussion, the relative risk of the engagement should be decided. If the risk is considered excessive, the engagement should be refused. The degree of risk associated with the engagement will then be used to modify or extend the audit procedures to be followed and/or assign more experienced personnel to the engagement.

Risk evaluation, as has been shown, is not a one-time proposition. Not only should the relative risk be evaluated before each audit, but the estimation of risk should be

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[2]Sharaf and Mautz are the originators of this three-dimensional type of independence. The outline above is from their work. For a fuller discussion of their concept, see Hussein A. Sharaf and R. K. Mautz, "An Operational Concept of Independence," _The Journal of Accountancy_, CIX (April, 1960), 49-54.

continually revised throughout the course of the audit as new facts are learned. Risk evaluation should be a continuous process.

There are many hurdles in the path to implementing a meaningful program of risk evaluation. To begin with, members of the leading accounting firms must find some way of pooling their individual information regarding lawsuits, disciplinary actions, industry studies, client problems, etc. In order to conduct successful research in the area of auditing, it is imperative to have a data base. So long as firms guard their information, it is impossible to build such a data base. Practitioners are well aware of the really important problems facing the public accounting profession. What is needed is a systematic program of research in these areas. Relative risk is one such area; there are numerous others.

Auditing research can be characterized as haphazard at best. Practitioners tend to "fight current fires" rather than anticipate rational solutions to potential problems. A vivid example is that of audit procedures regarding information learned in the course of a subsequent review. The SEC had long required the auditors to perform subsequent reviews from the date of certification to the date of filing and then to the effective date. All material facts in the course of the subsequent review were to be fully disclosed in the financial statement. The question that should have

been asked by the alert auditor was "What procedures should be followed if the subsequent facts would alter the opinion rendered?" The results of failure to ask this question led to lawsuits in the audits of Yale Express Systems, Continental Vending Machine, and BarChris Construction Company.[3] After the damage had been done, the Committee on Auditing Procedures issued guidelines to follow in the disclosure of events discovered in the course of a subsequent review.

This dissertation has attempted to present a systematic approach to one of the problem areas facing today's practitioner. It is a starting point. The facts uncovered and the suggestions offered need to be refined and implemented by practitioners. The available evidence shows that the risk relationship is valid, and there should be a concentrated effort by all firms to develop their own distinctive program for risk evaluation. Without such a program in the future, the lawsuits and disciplinary actions are likely to increase. However, if such programs could be implemented, the trend might be reversed. It is hoped that this study can contribute to both the immediate and long run needs of the professional accountant.

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[3]See Appendix A, Case Nos. 8, 7, and 6.

APPENDIX A

Contained in this appendix is a brief outline of twenty-five recent lawsuits and disciplinary actions brought against members of the "Big Eight" accounting firms. The outlines summarize salient facts in each case and, where possible, a description of the events leading up to the actions. Prior to this study there has been no effort to gather several of the cases together and use them as a data base. The sole purpose of these outlines is to provide the much needed facts for any meaningful investigation into the relative risks faced by the auditors. Because of the sensitive nature of lawsuits and disciplinary actions brought against professional individuals, it is extremely difficult to gather a large enough sample of cases to allow an investigator to draw any conclusions that would have real meaning. There is no effort in this study to draw such conclusions; rather, the cases and disciplinary actions serve as raw facts that are used to help support some of the contentions concerning relative risk.

The appendix contains those cases that have received widespread publicity in the financial and business press. The appendix does not contain several cases that are available, as they were outdated, dealt with trivial issues that had no real significance for this study, or they did not involve

members of the "Big Eight" accounting firms. Listed below are some of the cases and disciplinary actions reviewed but excluded from the appendix for the reasons stated above:

SEC Accounting Series Release #19, In the matter of McKesson & Robbins, Inc.

SEC Accounting Series Release #48, In the matter of C. Cecil Bryant.

SEC Accounting Series Release #59, In the matter of Williams and Kingsolver.

SEC Accounting Series Release #82, In the matter of Bollt and Shapiro.

SEC Accounting Series Release #105, In the matter of Homer E. Kerlin.

Glanzer v. Shepard.

Hedley, Byrne & Co. Ltd. v. Heller & Partners Ltd.

Maryland Casualty Co. v. Cook.

Teich v. Arthur Andersen & Co.

U. S. v. Martin Benjamin et al.

National Surety Corp. v. Lybrand et al.

Ultramares Corp. v. Touche et al.

Beardsley v. Ernst et al.

Cereal Byproducts Co. v. Roy Hall et al.

Chandler v. Crane, Christman & Co.

American Indemnity v. Ernst & Ernst.

Edwin A. Landell, Jr. v. William M. Lybrand et al.

H. L. Green Co. Inc. v. Louis F. Childree et al.

State Street Trust Co. v. Ernst et al.

Each outline in this appendix gives the name of the company involved, followed by the public accounting firm involved

in the action. The appendix is arranged in chronological order.

It should be called to the reader's attention that many of the companies mentioned in this appendix are relatively small, and in some cases the reader may have never heard of a particular company. This does not indicate that the damage to the accounting firm's reputation is minor. It has been claimed that some large accounting firms spend a disproportionate amount of time on larger clients and that "CPA's can become involved in serious difficulties on relatively small engagements."[1]

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[1] Norman O. Olson, "The Auditor in Legal Difficulty—What's the Answer?" The Journal of Accountancy, CXXXIX (April, 1970), 3[illegible]

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(1) Seaboard Commercial Corporation[1]
Touche, Ross & Co.[2]

This case involves an action by the Securities and Exchange Commission against the public accounting firm of Touche, Ross & Co. The proceedings were instituted under Rule II (e) of the Rules of Practice of the SEC.[3] This rule allows the Commission to bar from practice any person lacking the qualifications or integrity required to act in a professional manner.

The Commission claimed that Touche, Ross & Co. certified financial statements of Seaboard Commercial Corporation that were "materially misleading." The statements referred to were the 1947 Balance Sheet and Income Statement of Seaboard.

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[1]Accounting Series Release #78, March 25, 1957, Federal Securities Law Reporter, Commerce Clearing House, N. Y.

[2]At the time of these proceedings, the firm was known as Touche, Niven, Bailey & Smart.

[3]Rule II (e) is as follows:
(e) The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before or in any way to any person who is found by the Commission after hearing in the matter
(1) Not to possess the requisite qualifications to represent others; or
(2) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct.

A brief historical sketch of Seaboard will shed some light on the changing conditions under which the Touche Ross audit was conducted.

Seaboard started in business just prior to World War II as a small finance company. It was engaged almost exclusively in the financing of wholesale and retail automobile sales. After several years in the business, Seaboard expanded its business into the financing of accounts receivable and gradually into the financing of inventories. With the outbreak of the War, the Company experienced very rapid growth. Seaboard acquired its first manufacturing subsidiary during the early years of the War.

Shortly after World War II, the Company found itself in a rather precarious position. Virtually all of its loans were concentrated in six small manufacturing companies. All of these companies experienced severe downturns in sales and income in the post-war years. Seaboard continued to finance the companies during this downturn. By 1947, it had become apparent that Seaboard's future was directly linked to the future of the six companies. The situation became critical when in 1947 all of the companies experienced rather substantial losses. The 1947 audit proved to be the problem audit for Touche, Ross.

Perhaps the most serious charge made by the SEC concerned the provisions for possible losses and contingencies and the

balance sheet note relating to the provisions. Both the management of Seaboard and the auditor knew that the 1946 provision of $120,000 was inadequate for 1947. A representative of Touche, Ross & Co. estimated that the reserve should be about $1,450,000 based on the developments in 1947.[4] However, after considerable discussion between Seaboard and the audit partner in charge of the client, a reserve of $857,000 was established. As it turned out, the SEC considered this to be an inadequate reserve and indicated that the auditor should not have so readily reduced its previous estimate of $1,450,000.

Two other developments had a significant influence upon the SEC's final decision. First, the footnote used to explain the reserve increase was considered "materially false and misleading." It did not really explain the causes behind the increase. Second, the reserve was established through a charge to Seaboard's capital rather than taken through the income statement. By doing this, the company was able to show a profit of $250,000 rather than a loss of some $600,000. The Commission claimed that this action represented a failure to comply with generally accepted accounting principles and regulations of the SEC. A final charge in this matter was that by certifying the balance sheet and income statement of

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[4]This estimate did not include a reserve for one of the larger companies that was in financial difficulty. The reserve for this company was to be calculated separately but as later events showed, no reserve was provided. The SEC determined that this reserve alone should have been about $430,000.

Seaboard, the auditors failed to "exercise independent judgment."

As a result of the proceeding, Touche Ross was barred from practicing before the SEC for fifteen days.

(2) Kohler Company

Ernst & Ernst

Kohler Company is a well-known manufacturer of plumbing fixtures. It was organized as a closely held corporation having only twenty-six stockholders and 200,000 common shares outstanding. One of the larger stockholders, Walter J. Kohler, former governor of Wisconsin, wanted to dispose of his holdings in early 1953. The stock of the company was not traded and therefore had no readily determinable market value. The directors of Kohler Company asked Paul F. Johnson, a partner in Ernst & Ernst (the Company's auditors) to meet with Kohler and make "available the facts which might play a part in a discussion of (stock) values."[1] In addition to gathering information about Kohler Company and its major competitors, Johnson used financial data to project ten possible values for the stock.

At their first meeting, Kohler reviewed the data presented by Johnson and thought that a price of $125.00 per share was reasonable. Johnson mentioned the figure of $115.00 per share. Johnson reported the results of the meeting back to the directors, and they authorized him to purchase Kohler's stock at $115.00 per share. At their second meeting, Kohler accepted the offer and the transaction was finalized.

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[1] 208 F. Supp. 811.

About four years later, Kohler learned that Ernst & Ernst had completed their fieldwork on the 1952 audit just prior to his acceptance of the offer to sell, and that the 1952 financial data for the Company was made public six days after their final meeting. The 1952 financial information contained several items that came as a surpirse to Kohler. Earnings per share were up substantially, due primarily to a large tax refund and several lesser items. Upon learning this information, Kohler filed suit against Kohler Company and Ernst & Ernst.

The suit was brought to recover alleged damages of $10.00 per share. This amount represented the difference between "actual" or "fair market value" of the stock at the time of the sale and the actual purchase price. Kohler claimed that Johnson, while acting as agent for Kohler Company, misrepresented the company's true financial position and further that Johnson concealed certain information from Kohler that would have affected the final purchase price. In particular, it was claimed that Johnson withheld information about the tax refund and certain changes in accounting methods instituted in 1952 by Kohler Company. Kohler felt that if he had been made aware of these items, he would not have sold the stock for $115.00 per share, but would have insisted upon the price of $125.00 per share.

The court found for the defendants, Kohler Company and Ernst & Ernst. It stated that Johnson, as an agent, only had

a duty to make certain information available to Kohler. This duty did not include information that was not known to the general public because the court assumed that Kohler was more than an "ordinary stockholder," and knew much about the operations of Kohler Company. The court stated that Johnson's efforts to determine the "value" of the stock was an error in judgment on his part, for any attempts to do this should have been left solely to Kohler. The controlling fact in this decision was that the court could find no evidence of any willful acts, by the management of the company or Johnson, to misrepresent the financial data or defraud Kohler.

This case could have been easily avoided if Johnson had not compromised his position as an independent accountant. The court labeled Johnson an agent of the company, and it is doubtful if anyone would have considered him "independent." As an independent accountant, Johnson's sole function should have been to provide information about the company at the request of the directors. His efforts to determine stock prices certainly opened the case to the questions of whether or not he should have disclosed any additional data to Kohler. The facts in this case clearly indicate that Johnson acted as an agent rather than an independent accountant.

(3) Thomascolor, Incorporated[1]

Haskins & Sells[2]

The case involves Securities and Exchange Commission disciplinary proceedings against a large public accounting firm. The proceedings were brought under Rule 11(e) of the SEC Rules of Practice.[3]

Thomascolor was a small business that was still in the promotional stage when Haskins and Sells accepted the audit. The audit was in connection with a Registration Statement covering 1,000,000 shares of Thomascolor common stock.

Thomascolor was incorporated to assume the operations of several other small companies which were owned and operated by Richard Thomas, an inventor. Thomas had been trying to develop several new devices in the field of color photography for a number of years. All of his previous work had proven unsuccessful, and his creditors were attempting to get some type of payment from him. He decided to start a new company, Thomascolor, Inc., to provide adequate capital for further development work. Certain patents and patent applications

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[1]In the Matter of Haskins & Sells and Andrew Stewart. <u>SEC Accounting Series Release #73</u>, October 30, 1952.

[2]Also named in this proceeding was Andrew Stewart, the partner in charge of the Thomascolor audit.

[3]For an explanation of Rule 11(e), see Seaboard Commercial Corporation, Footnote 3.

were to be transferred by Thomas to Thomascolor for stock in the new corporation.

A review of the entire proceedings indicates that the move to incorporate was designed to accomplish two aims. The first objective was to release the pressure from Thomas's creditors and, second, to allow him to remain in control of the new company. The proposed stock issue was very complicated; it had two different issues with varying voting rights.

The SEC charged that the "financial statements in the Registration Statement as originally filed were highly misleading."[4] The central issue in the proceedings involved the "Patent and Patent Applications" account. It was claimed that certain amounts were included in this account without proper accounting evidence as to their nature or character. The patents, transferred by Thomas, were valued at the "value" of the stock issued to him. The value attached to the patent was thought to be artificially high. Another questionable asset was some $700,000 which represented the "value" of stock "expected" to be donated by the promoters of Thomascolor. The SEC questioned the validity of this "asset" and the transaction behind it.

It is interesting to note that the stock was never issued, and no one had claimed any damages as a result of the misleading statements. Rather, the SEC instituted this proceeding

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[4]SEC Accounting Series Release #73, Commerce Clearing House Federal Securities Law Reporter, p. 62, 187.

because it felt the auditors failed to act in a professional manner.

The proceedings resulted in a ten-day suspension of Haskins & Sells from practicing before the Commission. This represents no real penalty to the firm and does little to increase the power or authority of the SEC.

(4) Atlas Plywood Corporation

Peat, Marwick, Mitchell & Co.

The Atlas Plywood case is of special interest because it was the first of the current widely publicized cases against a major national accounting firm.[1] Actually, there are two national firms involved: Peat, Marwick, Mitchell, the company's auditors prior to 1957, and Arthur Andersen & Co., the company's auditors in 1957 and subsequent years.

Atlas Plywood was founded in 1925, by the merger of several small plywood manufacturers. Atlas had no major stockholders and was run exclusively by one man: Elmore I. MacPhie. The company was completely dominated by MacPhie's personality. All decisions were made by MacPhie and no discussion was allowed on any of the decisions made. In fact, "MacPhie rarely told his directors or his executives any of his plans beforehand."[2]

Soon after World War II, Atlas began to run into stiff competition from two sources. First, the container market was being taken over by the paperboard manufacturers, and second, cheap Japanese hardwood paneling was beginning to flood the American market. Faced with this new competition,

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[1] Actually, the McKesson & Robbins case in the 1930's was the first to gain nation-wide attention, but this case represents the first of the new cases against public accountants.

[2] "The Mess at Atlas Plywood," *Fortune*, LVII (January, 1958), 119.

MacPhie was reluctant to change and enter the new fields. He did attempt to diversify into the paperboard field, but it was strictly on a small scale. In 1954, the results of MacPhie's policies began to show; sales dropped 14 per cent and profits 64 per cent. Even in the face of stiff opposition from his directors and officers, MacPhie refused to change his operating policies.

In early 1955, a disaster struck Atlas Plywood; MacPhie died at the age of 65. There was no one with the company experienced and knowledgeable enough to run it. MacPhie had retained all the power and his executives had little experience in decision-making, although several of them felt that they were capable of running the company. After a brief attempt to run the company by MacPhie's executive failed, a corporate "raider," Maurice Clairmont, seized control after a proxy fight.

Clairmont and his team took control of Atlas Plywood in early 1957 and were dismayed at the financial condition of the company. The chief financial officers called in the current auditors, Peat, Marwick, Mitchell, and told them that they had lost the Atlas account and would be sued by the new management for certifying to "faulty and misleading financial statements in the Atlas annual reports."[3]

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[3]*Ibid.*, p. 118.

This action resulted from a 1957 audit of Atlas by Arthur Andersen & Co. The audited 1957 statements showed an operating loss of about $4,500,000, as compared to 1956 income of some $400,000. In addition to the operating loss, Arthur Andersen insisted that Atlas make certain special charges against 1957 income in the amount of $6,300,000. This brought the total loss for 1957 to over $10,000,000. One of the major audit adjustments was to the accounts receivable. In 1956, Peat, Marwick, Mitchell considered an allowance for doubtful accounts of $150,000 to be adequate. However, in 1957, the allowance was increased to $700,000, with an additional $450,000 being written off directly.

Ill feeling between the two auditing firms started as soon as Peat, Marwick, Mitchell learned it had lost the Atlas account. Threatened with a lawsuit, they refused to let representatives of Arthur Andersen examine their working papers for the 1956 audit.[4] In their 1957 audit report, Arthur Andersen made several comments that could be misinterpreted by readers of the financial statements. The thrust of the comments, coupled with the President's letter, was that some of the 1957 losses should have been recognized in earlier years. The reference being that Peat, Marwick, Mitchell had not performed adequate audits in previous years.

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[4]It is common practice for an outgoing firm to answer certain questions about an audit engagement for a new firm taking over the job. However, it should be noted that legally audit work papers are the property of the firm that conducted the audit, and as such do not have to be shown to any outsider.

The details of the fall of Atlas Plywood received wide coverage in the financial press and did little but damage the reputations of both public accounting firms involved.

No announcement of any settlement in the threatened lawsuit has been made. It is possible that the suit was never formally filed against Peat, Marwick, Mitchell.

(5) Brunswick Corporation

Arthur Andersen & Co.[1]

In early 1961, the Brunswick Corporation offered for sale about $25,000,000 in convertible subordinated debentures, and in connection with this sale, they filed a Registration Statement with the Securities and Exchange Commission. The debentures were convertible into Brunswick's common shares at the price of $51.00 per share. Colonial Realty Corporation purchased 12,300 shares of Brunswick's common stock of the same class covered by the Registration Statement for the sale of the debentures. The shares were purchased in the middle of 1961, at a cost of about $750,000, and sold sometime later at about $300,000. In addition to these common shares, Colonial Realty Corporation purchased an additional 19,200 common shares at a cost of about $950,000, and these shares had a market value of approximately $22,000 at the time of the suit. Colonial filed suit against Brunswick Corporation, the underwriters of the debentures, and the auditors who aided in the preparation of the Registration Statement.[2]

The suit was filed under Section 11 of the Securities Act of 1933, claiming the issuance of false and misleading

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[1]While the accounting firm involved in the suit was never named by the court, Moody's Industrial Manual indicates that Arthur Andersen & Co. was the auditor in 1961.

[2]257 F. Supp. 882.

information in their Registration Statement. Colonial claimed that it had relied upon the Registration Statement when it made its purchase of Brunswick common and suffered a loss as a result of their reliance.

The relevant portion of Section 11 is as follows:

> (a) in case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may . . . sue. . . .[3]

The main issue in the suit revolved around a financial agreement between C. I. T. Corporation and Brunswick. Colonial charged that Brunswick and their accountants classified the $126,000,000 loan from C. I. T. to Brunswick as a current liability to avoid revealing the interest rate on the loan.

The financing agreement between C. I. T. and Brunswick started in 1957 and was to run through 1962. The terms of the agreement called for Brunswick to assign to C. I. T. 80 per cent of its installment notes receivable related to pin-setting machines and to borrow at least 70 per cent of the assigned value of the receivables up to a $125,000,000 limit. The rate of interest was to be 6½ per cent above the prime rate, i.e., 11 to 11½ per cent during 1960. At this time, Brunswick was charging its customers about 6 per cent simple interest on their notes. Therefore, the cost to Brunswick

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[3] 257 F. Supp. 882.

was somewhere between 5 and 5½ per cent on all receivables assigned to C. I. T.

While no mention was made of the details of this agreement in the Registration Statement, a detailed analysis of other long-term debt was presented as required by the Securities and Exchange Commission. The other long-term debt amounted to about $11,000,000, and the interest rates varied from 4 to 5 3/4 per cent.

In his opinion, Judge Edlestein pointed out that the financing from C. I. T. was Brunswick's "chief source of debt" and that "the propriety of listing the financing under the heading of current liabilities in the Prospectus balance sheet is, at the very least, open to serious question."[4]

The decision in this case was for the defendants because it was shown that Colonial did not purchase any common stock issued upon conversion of the debentures; the shares they did purchase were, however, of the same class of stock. The judge stated that "such a suit may be maintained only by one who comes within a narrow class of persons, i.e., those who purchase securities that are the direct subject of the Prospectus and Registration Statement."[5]

Even though the action proved unsuccessful on the part of Colonial, it is not unrealistic to assume that if an individual

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[4]257 F. Supp. 883.

[5]*Ibid.*, p. 880.

could show that he was a purchaser of the debentures mentioned in the Prospectus, subsequently converted the debentures into common stock, and that he relied upon the financial statements in making his purchase, he could sustain a successful action. From the language of the judge in the case, it is obvious that he considered the Registration Statement to contain material omissions.

(6) BarChris Construction Corporation

Peat, Marwick, Mitchell & Co.

BarChris was engaged in the construction and operation of bowling centers. Most of the centers included restaurants and bars in addition to bowling facilities. The construction of centers was the primary source of the Company's revenue, as only a few alleys were actually operated by them.

Although ranked third in the industry, BarChris had only about 3 per cent of the total market. They were greatly overshadowed by the two industry giants--Brunswick and American Machine and Foundry.

The bowling industry, in general, experienced rapid growth between 1950 and 1960. The growth was due primarily to the perfection of the automatic pin spotter. BarChris entered the picture at the end of this growth period. Their net sales increased from about $800,000 in 1956 to $9,200,000 in 1960. This rapid rate of growth, coupled with other factors, caused several critical problems for the company.

When the company was relatively small, its founder had little trouble managing it. However, as BarChris began to grow, management limitations became evident. Pugliese, the company's Vice President, devoted his time to the supervision of construction work, and Vitolo, the President, was concerned

with the sales end of the business. Neither of the founders was "equipped to handle financial matters."[1] In fact, it has been pointed out that prior to its demise, "the business had exceeded the managerial capacity of its founders."[2] Both men had only limited education.

Between 1954 and 1960, BarChris hired two former Peat, Marwick, Mitchell employees to handle the financial side of the business. By the time these men were hired, many of the company's financial policies had already been set. Basically, BarChris used two methods of financing the sale of its bowling centers. The first method was to get a small down payment and a note for the remainder of the contract price of the center. They then proceeded with the construction work. BarChris discounted the note received from the customer. Under this method, the company had a contingent liability on the notes discounted in case of default by their customer. The alternative to this method of financing involved a sale and a lease-back arrangement. Under this arrangement BarChris would construct and equip the "interior" of the bowling center (which meant installing the equipment) and sell this package to a factor. In turn, the factor would lease the interior to the customer or back to a subsidiary of BarChris (in which case the subsidiary would lease to the customer).

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[1] 283 F. Supp. 653.

[2] Ibid.

Under either method of financing, the company was placed in a very weak cash flow position. BarChris was required to make substantial outlays for construction costs before it received any cash from the factor or the customer. As a result of their financing methods, and their rapid growth, the company was in constant need of cash.

By early 1961, the company began to experience some difficulty in collecting from its customers. It became obvious to most observers that the industry was overbuilt. In May, 1961, BarChris sold an issue of convertible debentures; the proceeds from the sale were desperately needed to improve the company's working capital position. The industry situation worsened as many bowling alley operators were going out of business in early 1962. In October of that year, BarChris tried to raise more money through the sale of common stock; but the issue failed. With the failure of this issue, the company was bankrupt and defaulted on the debenture interest payment.

A suit was filed under Section 11 of the Securities Act of 1933 by the holders of the debenture issue. Named along with other defendants in the suit were the company's auditors, Peat, Marwick, Mitchell. The suit claimed that "the Registration Statement with respect to the debentures filed with the Securities and Exchange Commission . . . contained material false statements and material omissions."[3]

[3] 283 F. Supp. 652.

After six years of litigation the judge ruled, among other things, that the 1960 Balance Sheet of BarChris did contain material false statements and omissions. He also found that the review of subsequent events was inadequate, and the auditors did not make a "reasonable investigation" of events subsequent to the balance sheet date.[4]

The material errors found in the financial statements dealt with the recognition of revenue under the percentage-of-completion method, the estimating of provisions for bad debts and other contingencies, and the classification of assets. It was determined that inaccurate estimates of the degree of completion of bowling allies in process of construction resulted in overstating revenues by about $650,000 (with a resulting $250,000 overstatement of income). The court further concluded that provisions for contingencies were understated by some $1,000,000. Finally, the court ruled that $150,000 of receivables from consolidated subsidiaries was classified improperly as trade accounts receivables, and $145,000 in the cash account should have been classified as an investment for statement purposes.

The court found all defendants guilty of violations of Section 11 of the 1933 Act. The case has received widespread

[4] A "subsequent review" is an investigation by the auditors of material events between the date of the financial statements and the last day of his field work. In this case, the review was from the date of financial statements to the date of the Registration Statement.

publicity in the financial press, as it dealt directly with the liability of all persons signing a registration statement.

No settlement has been announced because all defendants have filed cross-claims against each other for payment of damages. However, it seems likely that all parties will have to bear some cost in the case.

(7) Continental Vending Machine Corporation

Lybrand, Ross Bros. & Montgomery

The events in this case actually revolve around the relationship of two affiliated companies: Continental Vending Machine Corporation and Valley Commercial Corporation. Continental Vending was engaged in the manufacture and maintenance of a variety of coin-operated vending machines, and Valley's primary business was the financing of vending machines sold by Continental. As an incidental part of its business, Valley also made commercial and personal loans.

Harold Roth was the president and largest stockholder of Continental Vending (controlling about 22 per cent of the outstanding shares). Valley Commercial was also run by Roth who owned about 20 per cent of its outstanding stock. From time to time, Continental Vending made substantial advances to Valley Commercial, and Valley made payments to Continental for these advances. For the fiscal year ended September 30, 1962, the advances by Continental amounted to $3,500,000.

During the course of their 1962 audit, Continental Vending's independent accountants, Lybrand, Ross Bros. & Montgomery, learned that the advances from Continental to Valley merely served as a conduit through which Roth gained control of the money. Roth had borrowed heavily from Valley in hopes of using the money to finance a purchase of another company.

"Effectively, he was applying for his own purpose funds advanced by Continental to its affiliate Valley."[1]

Roth admitted the existence of the arrangement to the auditors, and during further discussions with him, it was learned that he was unable to repay his loan to Valley. This, in turn, meant that Valley was unable to repay the advance from Continental. Roth stated that he would secure his loan from Valley. He produced marketable securities in his name, about half of which were shares of Continental, to secure the loan.

To reflect all of these facts, the auditors prepared controversial Footnote Two to the 1962 financial statements. The footnote was designed to disclose the relationship between Roth, Continental, and Valley and reads as follows:

> The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr. Harold Roth is an officer, director and stockholder) bears interest at 12% a year. Such amount, less the balance of the notes payable to that company is secured by the assignment to the Company of Valley's equity in certain marketable securities. As of February 15, 1963 (date of certification of financial statements) the amount of such equity at current market quotations exceeded the net amount receivable.[2]

The financial statements were now ready for release. It should be noted, however, that Continental's pre-audit income of $100,000 was changed to a loss of some $800,000 as the

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[1] J. M. Renshall, "BarChris and Continental Vending--1968's Legacy for American Auditors," *Accountancy*, LXXX (January, 1969), 8.

[2] *Ibid.*, p. 9.

result of an audit adjustment to write off certain research and development costs.

Shortly after the statements were issued, the market value of Continental's stock (which had fallen from $16.00 per share to $4.00 per share in 1962) began to fall. This resulted in the evaporation of the security on the loan from Valley to Roth. In addition to this, the auditors learned of a check "kitting" scheme that involved about $1,300,000, and the practice by Continental of "fradulently financing fictitious accounts receivable through a commercial factor."[3]

Lybrand, Ross Bros. & Montgomery refused to certify Continental's 10-K that must be filed annually with the Securities and Exchange Commission. A short time after the refusal, the company went into reorganization under Chapter X of the Bankruptcy Act.

The trustee in bankruptcy soon filed a $41,000,000 civil suit against Roth, Lybrand, Ross Bros. & Montgomery, and a large creditor bank. The suit claimed that the defendants had entered into a scheme to defraud Continental through concealments and misrepresentations.[4] The civil suit was settled out of court for $2,100,000.

Lybrand was to pay some $2,000,000 in cash and release claims against Continental in the amount of $100,000. The settlement was approved by the court.

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[3] The Wall Street Journal, October 18, 1966, p. 21.

[4] Ibid.

The above suit is only of secondary importance to the auditors. Soon after the civil suit was filed, the Federal government filed criminal charges against two partners and a manager of Lybrand, Ross Bros. & Montgomery. The suit was brought under Section 32 of the 1934 Securities and Exchange Act. This Section makes it a criminal offense to willfully and knowingly make any statement in a required report which is false or misleading as to material facts of a company. The government claimed that the Lybrand, Ross Bros. & Montgomery men were guilty of fraud because they knowingly failed to disclose the following material facts:

1. That the receivable and payable between Continental and Valley could not be offset against each other;

2. That the advances from Continental to Valley had increased by $400,000 between September 30, 1962 (fiscal year end) and the date of certification;

3. That as of the date of certification the value of the securities was less than the amount of the advances by some $900,000;

4. That most of the securities were stock and convertible debentures of Continental.

At the end of the first trial, the jury was unable to reach a decision in the case. The retrial resulted in a guilty verdict for the three men. The men were fined a total of $17,000, and no prison terms were assessed. All appeals failed, and the conviction of the men stood.

(8) Yale Express System, Inc.

Peat, Marwick, Mitchell & Co.

Yale Express was a medium-sized trucking company when Gerald W. Eskow took control of the company from his father. The company had established a good reputation for providing fast service to the small and often neglected companies in need of trucking service. Eskow prided himself on the introduction of the latest technology in the industry. The company continued to grow at a rather moderate rate in the first years of his control. In 1963, Yale decided to purchase Republic Carloading Distributing Company, a leading company in the freight forwarding business. Republic was approximately twice as large as Yale and could operate nation wide, whereas Yale had only serviced the New York-New Jersey area. Unlike the business of a trucking company, a freight forwarder "is a broker who purchases transportation and provides as little service as possible to preserve his narrow margin."[1] Yale was built on the philosophy of customer service, and Eskow felt that this philosophy could be carried over to the freight forwarding business. Unfortunately for Eskow, he did not realize until too late that there are vast differences in operating the two types of companies.

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[1] Richard J. Whalen, "The Big Skid at Yale Express," Fortune, LXXII (November, 1965), 147.

Peat, Marwick, Mitchell performed the 1963 audit of the newly expanded Yale Express. Reported net income for the year was $1,140,000. The figure was a great disappointment to Eskow as he expected income to be somewhere around $3,000,000. (Actually, just after the merger with Republic, it was felt that pre-tax earning would be about six to seven million.) As a result of his disappointment, he hired Peat, Marwick, Mitchell to undertake a study to determine what was going wrong.

Peat, Marwick, Mitchell was aware of some of the problems that existed and discovered many more as a result of their study. Internal control in both companies was weak, and the merger tended to compound the problem. Each company used a different type of accounting system. Republic was on a full accrual system, while Yale was using a modified cash-basis type of accounting. All efforts by management to merge the two systems failed. As an example of the weakness of internal control, the controller of Yale learned that bank reconciliations had not been made for five months. Upon preparing a reconciliation, it was discovered that $438,000 in checks had been written and not recorded on Yale's books. The cancelled checks and vouchers had been stored in boxes and never recorded. This had the effect of overstating the company's cash position.

Open hostility soon broke out between the management of Yale and Republic. This merely added to all the other problems.

"According to the auditors, few of the studies were ever completed for often when they produced evidence or inefficiency or mismanagement, the assignment was changed."[2]

Yale continued to report disappointing profits for 1964. However, as a result of their study, Peat, Marwick, Mitchell discovered that in 1964 the company had sustained a loss of some $3,300,000, instead of an anticipated profit of about $1,800,000. The real problem that concerned the auditors was that the audited 1963 income figure of $1,140,000 should have been reported as a loss of $1,880,000. It is not known when in 1964 they discovered the errors, but the information was not made public until May, 1965, when they completed their study.

Soon after the information became known to the general public, Yale could not obtain much needed bank credit and was soon forced into bankruptcy.

Several stockholders and bondholders of Yale filed suit against Peat, Marwick, Mitchell claiming "damages for errors and omission" in the 1963 audited financial statements, unaudited statements contained in a prospectus filed with the SEC in 1963, and unaudited interim statements for 1964.[3] The plaintiffs claimed that Peat, Marwick, Mitchell was liable because they failed to disclose the fact that the 1963

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[2] _Ibid._, p. 149.

[3] _Fisher_ v. _Kletz_, 226 F. Supp. 180.

statements "contained false and misleading figures," and the fact that they knew that the 1964 interim statements contained inaccurate figures.[4]

The rather unique question that will be answered during the trial is whether or not an "independent" accountant owes any duty to the general public for information learned after the certification of the financial statements. Peat, Marwick, Mitchell was not acting in its role as an "independent" accountant when it learned of the errors in the financial statements. The decision in this case may have a significant impact on the future of management services provided by accounting firms.

Peat, Marwick, Mitchell filed a motion to dismiss the complaints, but this motion failed, and the case will go to court.

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[4] Ibid., p. 183.

(9) Marrud, Inc.,

Touche, Ross & Co.

Prior to its demise, Marrud, Inc. sold health and beauty products through lease departments in several discount stores throughout the country. The collapse of Marrud is closely linked with one of its subsidiaries, New Sun Ray Drug, Inc. New Sun Ray Drug was a drug wholesaler dealing primarily with the outlets owned by its parent, Marrud.

In early 1965, Marrud tendered a public offering of common stock, and in connection with the offering, it filed the mandatory Prospectus and Registration Statement with the Securities and Exchange Commission. Shortly after the issue was successfully sold to the public, the American Stock Exchange stopped trading in Marrud stock because the company "failed to issue definite financial information within a specified period."[1]

Following this stop order, the company, its auditors, Touche, Ross & Co., and others were named as defendants in at least two stockholder suits. The suits claimed that the Prospectus and Registration Statement filed in 1965 contained false statements and omitted material facts. In particular, it was alleged that the propsectus failed to tell the reader that Marrud was not able to declare dividends because of

[1] *The Wall Street Journal*, February 21, 1966, p. 10.

certain restrictions in creditor agreements. The Prospectus merely stated that about $1,100,000 would be available for payment of dividends "upon completion of the offering."[2]

Within four months of the filing of these lawsuits, Marrud and New Sun Ray filed a petition under Chapter XI of the Bankruptcy Act. They asked the court to allow them to operate while they attempted to reach some settlements with their creditors. The company announced that it had suffered a $6,000,000 loss for their fiscal year 1966. Their stock, which sold for $16.375 per share at the 1965 public offering, was now selling for $1.375 per share.[3]

The primary reasons for the large loss in 1966 were the losses associated with two subsidiaries: New Sun Ray and Clifton Private Brands. The company also reported losing several of its major customers in the 1965-66 period.[4]

There has been no announcement of a settlement in this case, and it is assumed that the suit is still in the pre-trial state.

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[2] Ibid., p. 11.

[3] The Wall Street Journal, August 26, 1966, p. 12.

[4] The Wall Street Journal, August 22, 1966, p. 13.

(10) Thor Power Tool Company

Peat, Marwick, Mitchell & Co.

Thor Power Tool Company had entered into merger negotiations with Stewart-Warner Corporation in 1965. As part of the negotiations Thor Power Tool submitted its 1965 financial statements which had been attested to by Peat, Marwick, Mitchell, Thor's auditors. Shortly after receiving the statements, Stewart-Warner and its auditors claimed that Thor's inventory had been overstated by $8,500,000. As a result of this overstatement, the merger negotiations broke down completely. The value of Thor's stock declined when the reason was learned for the halt in the merger talks.

At the next annual meeting of Thor, the old management which originated the merger talks was ousted and a new management group instituted. However, the stockholders were still not satisfied and brought suit against the new management for losses suffered as a result of the collapse in the merger negotiations. The suit also named as co-defendant the company's auditors, Peat, Marwick, Mitchell. To protect itself from paying any damages as a result of the lawsuit, the new management filed a cross suit against the old management and Peat, Marwick, Mitchell. The two suits against the auditing firm have since been consolidated into one action.[1]

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[1] See _Drake_ v. _Thor Power Tool Company_, 282 F. Supp. 94.

Peat, Marwick, Mitchell contended that the old "management was informed of the overstated inventory but apparently decided to withhold the information in its representations to the Stewart-Warner officials lest it jeopardize the terms of the merger."[2] So in fact, Peat, Marwick, Mitchell had admitted that the inventory value attested to by them in the financial statements had been overstated, and they knew of the overstatement.

Thor and Peat, Marwick, Mitchell were charged in the lawsuit with "falsifications of its inventory and sales figures and issuing financial statements reflecting such false figures."[3] Further, Peat, Marwick, Mitchell was charged with "applying inappropriate accounting procedures with respect to the Thor audit and uttering untrue certifications of Thor's false financial statements."[4]

The suit was brought under Section 10(b)-5 of the Securities Exchange Act of 1934. The relevant portion of this section states the following:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentability of interstate commerce, or of the mails, or any facility of any national securities exchange . . .
> (b) To make any untrue statement of a material fact or to omit to state a material fact

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[2]T. A. Wise, "The Very Private World of Peat, Marwick, Mitchell," *Fortune*, LXXIV (July 1, 1966), 90.

[3]*Drake* v. *Thor Power Tool Company*, 282 F. Supp. 96.

[4]*Ibid.*, p. 96.

> necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading . . .[5]

Peat, Marwick, Mitchell asked the court to dismiss the charges in the stockholder suit, claiming that it had not benefited from the supposedly inflated price of Thor's stock and that it was not the intent of Congress to provide a civil remedy under Section 10(b)-5. However, the judge refused to dismiss the suit.

Shortly after this decision was reached, Peat, Marwick, Mitchell settled the suit out of court for $475,000.[6] As in most major cases against public accounting firms, a long legal battle of four years preceeded the settlement.

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[5] *Ibid.*, p. 97.

[6] *The Wall Street Journal*, June 10, 1970, p. 3.

(11) Livingston Oil Company

Peat, Marwick, Mitchell & Co.

The case was brought as a result of a speech made to several security analysts by the President of Livingston Oil Company. In his speech before the New York Society of Security Analysts, Julius Livingston stated that he expected earnings for the fiscal year ending May 31, 1965, to be about $3,500,000 or about $.90 per share and cash flow to increase to about $6,000,000.[1]

However, about a month after the speech, the company reported a loss in the third quarter and a drop in cash flow. Actual year-end earnings amounted to about $1,900,000 ($.48 per share), and cash flow was off about $1,000,000.

The suit was filed on behalf of a group of ninety stockholders and claimed that they were induced to purchase stock as a result of Livingston's speech, which proved to be misleading and inaccurate. The stockholders claimed damages of $1,000,000.[2] Peat, Marwick, Mitchell, the company's auditors, were also named as defendants in the suit. It was alleged that they provided Livingston with the figures he quoted in his speech.

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[1] The Wall Street Journal, September 26, 1966, p. 10.

[2] Ibid.

There has been no announcement of any settlement or offer to settle by any of the parties involved.

(12) San Francisco National Bank

Peat, Marwick, Mitchell & Co.

This case is an example of the adverse publicity received by public accounting firms where the facts relating to the case are difficult to discern from the available literature. The story was carried for several days in the financial press, and after that, no further mention is made of the Bank's failure.

The bank failed in early 1965, and as a result, the Federal Deposit Insurance Corporation filed suit against fifteen former directors for recovery of an estimated $10,000,000 in damages. In turn, one of the directors filed suit against the bank's auditors, Peat, Marwick, Mitchell & Co., for damages that he might be assessed as a result of the FDIC suit.

The bank's founder and former president had been convicted of "violating Federal banking law, including laws against misappropriation of bank funds," about nine months before the bank's collapse.[1] He was sentenced to a 60-year prison term and was fined $60,000. However, the sentence could have been modified by the results of a court-ordered psychiatric examination. The former president is not involved in any of the suits mentioned above.

The suit by the former bank director claimed that Peat, Marwick, Mitchell & Co. "negligently failed to reveal the

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[1] *The Wall Street Journal*, September 28, 1966, p. 8.

acts, errors, and omissions and unlawful transactions in the affairs of the bank of which the directors were legally required to be aware."[2]

In filing the suit, certain correspondence between Peat, Marwick, Mitchell and the bank was made public. One of the letters dealt with Peat, Marwick's evaluation of the bank's internal control and stated that there existed "unsatisfactory internal control--but the bank's records generally are in satisfactory condition."[3] The suit went on to claim that the auditors made the above statement "without reasonable grounds for belief in their truth, thereby consciously misrepresenting such material facts and perpetrating a fraud upon the directors of the bank."[4] However, the auditors were not retained past November 15, 1963, some two years before the bank's failure, and claimed that the suit was without merit.

The suit asked $100,000 in punitive damages and exemplary damages for all amounts levied against the former director as a result of the FDIC suit.

It should be pointed out that this was a civil suit claiming negligence and fraud on the part of the auditors and does not involve any violation of the Securities Acts of 1933 and 1934.

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[2] Ibid.

[3] Ibid.

[4] Kenneth F. Byrd, "Accountancy and the Onslaught of Case Law in North America," The Accountant, CLVII (July 8, 1967), 38.

While there is no mention of a settlement in the case, it seems likely that either a very small out-of-court settlement was reached or the case was dropped. The reason for this belief is the difficulty encountered in proving fraud or negligence in court. The case law indicates that a recovery based upon these charges is extremely difficult to obtain.

(13) Atlantic Acceptance Corporation

Haskins & Sells

While there have been no lawsuits to date as a result of the financial collapse of Atlantic Acceptance, its story is of interest because of the adverse publicity received by the accounting profession in general and the corporation's auditors in particular.

Atlantic Acceptance Corporation was a large Canadian finance company. However, by American standards the company was relatively small, having total receivables of about $150,000,000 in 1965. Prior to 1965, the company had experienced tremendous growth. Its receivables increased from about $19,000,000 in 1960 to the $150,000,000 level just prior to its downfall. Also, during this period of time the company began to diversify its operations. By mid-1965, the company showed "about $60 million of sales financed receivables, over half of it motor car paper; about $38 million in small loans; and $52 million of commercial loans."[1] The commercial loans were the special responsibility of the President of Atlantic Acceptance and were handled through a subsidiary.

Atlantic Acceptance's financial difficulties can be blamed, at least in part, upon their rather unique method of financing. While their lending was almost exclusively Canadian, their borrowing was largely from the United States.

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[1] *Barron's*, August 16, 1965, p. 9.

The company's financing came mostly from large institutional lenders, primarily insurance companies in the United States. "Atlantic was short on bank lines, having only one line with a major Canadian bank."[2] About half of the company's total debt was term debt, and a large portion of the remainder was in short-term commercial paper. Financial difficulties arose when Atlantic found it extremely hard to renew its U. S. short-term obligations. For during this period of time, there was pressure on all American lenders to keep their money in the U. S., and thereby help the balance-of-payments situation.[3]

In addition to the problem of securing adequate financing, in about the middle of 1965, it was determined that several of the company's largest commercial loans might prove to be worthless. "One single commercial loan, the largest one made, was for $10 million---an amount larger than the entire stated common stock capital of the company, including surplus,"[4] proved to be only partially collectible after careful review of the account.

In accessing the blame for the downfall of Atlantic Acceptance, many writers have criticized the management and the independent auditors of the company. "As for the management element in Atlantic, the single speculative loan which

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[2]*Ibid.*

[3]*Ibid.*, p. 14.

[4]*Ibid.*

exceeded the entire common stock equity of the company speaks loudly enough."[5] The phenominal growth which Atlantic experienced prior to its downfall was achieved largely as a result of these speculative loans. The majority of these loans proved too risky for the company. This would indicate poor management of the loan portfolio by some of the esteemed officers of Atlantic, in particular, the former president of the company.

As for the accountants, it has been pointed out that "Atlantic took an unusually large part of its financial income into earnings as soon as it made a loan, thereby increasing immediate profits at the expense of future results."[6] The major problem that developed was that interest on loans that was never paid was taken into account in profit determination on a large scale. "By the rewriting of delinquent loans with the unpaid income on the old loans written into the new, the fact that interest was never collected and that loans were bad was obscured."[7]

The investors in Atlantic stock relied in a large part upon the auditor's evaluation of the collectibility of the loans. As shown in this particular incident, the auditor's report revealed very little to warn the investors of the

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[5] _Ibid._, p. 14. [6] _Ibid._

[7] Kenneth F. Byrd, "Accountancy and the Onslaught of Case Law in North America," _The Accountant_, CLVII (July 8, 1967), 41.

dangers that were just around the corner. The inference that most investors would derive from the auditor's clean opinion was that the receivables were almost fully collectible. It has been suggested that the auditor spell out in more precise terms the collateral behind such receivables. At a very minimum, the auditor's report should contain a listing of the major loans made by the finance company and the security of the collateral backing such loans.[8]

Finally, Atlantic had "too much short-term commercial paper in lieu of bank credit." and this proved to be another problem for the Company.[9]

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[8] *Barron's*, *op. cit.*, p. 14.

[9] *Ibid.*

(14) Frank G. Shattuck Company

Peat, Marwick, Mitchell & Co.

Frank G. Shattuck Company is an East Coast subsidiary of W. F. Schrafft & Sons, a large candy manufacturer. Relatively little is known about the problems that plagued Shattuck in 1965. One investor in Shattuck brought suit against Peat, Marwick, Mitchell & Co. claiming the firm conducted faulty audits in 1964 and 1965.

In early 1966, officials of Frank G. Shattuck Company announced that 1964 profits had been overstated by $210,000 and 1965 profits were overstated by $822,000. The overstatements were the result of "collusive fabrication of fictitious invoices and other accounting records by certain department heads (of Shattuck)."[1]

After the suit was filed, the management of Shattuck stated that the circumstances surrounding the collusion were so complicated that "it was not possible for Peat, Marwick to have caught the situation in the course of a normal audit."[2] While the auditors disclaimed any responsibility for the detection of fraud in the engagement letter to a client's management, this does not release them from the responsibility for detecting massive fraud.

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[1] The Wall Street Journal, May 23, 1966, p. 12.

[2] T. A. Wise, "The Very Private World of Peat, Marwick, Mitchell," Fortune, LXXIV (July 1, 1966), 89.

No mention of any settlement in this suit is given in the lterature. If any settlement was made, it was probably out-of-court and made prior to any litigation.

(15) Otis-McAllister & Co.
Peat, Marwick, Mitchell & Co.

Otis-McAllister is a large San Francisco-based coffee importer. The company was declared bankrupt in 1963 after several years of financial difficulties.

In 1965, four banks, including Bank of America (San Francisco) and Chase Manhattan of New York brought suit against Otis-McAllister's independent auditors, Peat, Marwick, Mitchell & Co., claiming that they attested to misleading financial statements from 1958 through 1960. The specific charge against the auditors was that they knew about certain improper uses of proceeds from specified coffee shipments. All four banks were creditors of Otis-McAllister and according to the terms of their loan agreement, receipts from the sale of certain coffee shipments were to be used to repay the loan. However, funds from these sources were used by the company for general corporate purposes rather than the required loan repayment. The banks claimed that they should have been notified of these irregularities by the auditors.

To further complicate the case, it was disclosed that Peat, Marwick, Mitchell & Co. was also the auditor for Chase Manhattan Bank during the years 1958 through 1960.

Peat, Marwick, Mitchell & Co. claimed that Chase Manhattan was well aware of the improper use of funds by Otis-McAllister, and in fact withdrew its line of credit based upon the knowledge.

Peat, Marwick, Mitchell & Co. was dismissed by Chase Manhattan as their auditor as a result of the Otis-McAllister suit.

No mention is made of a settlement in this case; however, a spokesman for Peat, Marwick, Mitchell & Co. stated that "the banks offered to settle the disputed liability for about $1.3 million, but (their) insurer decided against this approach."[1]

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[1] The Wall Street Journal, May 10, 1965.

(16) Belock Instrument Corporation

Lybrand, Ross Bros. & Montgomery

Belock Instrument Corporation was in the business of manufacturing precision instruments and electrical components. The company's primary customer was the Federal government. In 1965, it was alleged that the management and directors of Belock entered into a conspiracy to defraud the government. It was alleged that Belock overcharged the government on several contracts and that they failed to disclose these recoverable overcharges in their annual report filed with the Securities and Exchange Commission. Thus, it was claimed that the company knowingly overstated its earnings and understated its liabilities for 1964.

Several stockholders brought suit against Belock, its directors, and the public accounting firm of Lybrand, Ross Bros. & Montgomery, the company's auditors in 1964. The suits were brought under the Securities Act of 1933 and the Securities Exchange Act of 1934. The stockholders claimed that they had suffered losses on the purchase of Belock common stock and debentures when they relied upon the information in the 1964 annual report in making their investment decision.

The suits stated that all defendants knew or should have known that the statements were false and misleading and that such statements were issued with the intent of inflating the market value of Belock's stock.

All of the suits brought under the 1933 and 1934 Acts failed in this case.[1] The judge ruled that the false financial statements were not issued "in connection with the purchase or sale of any security," a necessary condition for a successful action under Rule 10(b)-5 of the Securities Act of 1934.[2] It can be assumed that if the same financial information was contained in a prospectus or registration statement, the action might have been sustained. The judge further stated that if a fraud was perpetrated, it was against the Federal government and not against the stockholders.

No mention of any government action against the defendants could be found in the literature. However, it can be assumed that any complaint by the government would be against Belock, rather than the auditors, for recovery of the overcharges or possibly criminal fraud charges.

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[1] 260 F. Supp. 602.

[2] 262 F. Supp. 645.

(17) Westec Corporation

Ernst & Ernst

Until its demise in 1966, Westec Corporation was a rapidly growing oil exploration and production company. Prior to 1963, the company was virtually unheard of by most investors. However, its stock climbed from $2.00 per share in 1964 to a high of about $67.00 prior to its collapse. In the years 1964 and 1965, Westec pursued a policy of vigorous growth. It began to diversify into the production of geophysical instruments and electronics and aerospace equipment by purchasing numerous small companies. At the annual meeting in May, 1966, the company's Chairman, James W. Williams, characterized Westec as follows: "If our plans can be described by one word, it is that nebulous overworked term growth . . . we believe the upper limit on internal growth in our sales and earnings is approximately 50% compounded annually. . . . To supplement this internal growth and overcome its limits we will make acquisitions."[1] A short four months after this statement, Westec collapsed.

The price of Westec's stock began to fall as security analysts began to question some of the accounting methods used by the company. In August, 1966, the company released the following short statement: "The directors had met to evaluate information concerning the apparent purchase of

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[1] The Wall Street Journal, September 6, 1966, p. 32.

approximately 160,000 shares of its common stock in recent weeks by or on behalf of its president, E. M. Hall, Jr."[2] Immediately following this announcement, the SEC suspended all trading in Westec stock; Hall was removed as president of the company; Williams resigned as Chairman.

The company soon filed voluntary bankruptcy petition under Chapter X of the Bankruptcy Act. A court-appointed trustee took over control of Westec and ordered a re-examination of the company's books by their outside auditors, Ernst & Ernst. It was soon learned that the company's previously reported earnings for the first half of 1966 of $5,300,000 was in actuality a net loss of $2,600,000.

Soon after the investigation was complete, a Federal grand jury indicted Hall and his brother-in-law, Lester I. Lilley, for conspiring to manipulate the price of Westec stock. They both pleaded guilty to these charges and were subsequently indicted for fraud. Hall also was indicted on "stock fraud and conspiracy charges."[3]

About the same time as Federal charges were preferred against the officers of Westec, a stockholder suit was filed against the officers and directors and against Ernst & Ernst. The suit claimed that the company "artifically inflated earnings statements in an effort to bolster artifically the price

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[2] The Wall Street Journal, September 6, 1966, p. 32.

[3] The Wall Street Journal, January 9, 1968, p. 3.

of Westec stock."[4] The entire group of defendants was charged with having "engaged in acts, practices and courses of business which operated as a fraud or deceit."[5] In the complaint, the accountants were charged with (1) "Common law negligence for breaking contractual and fiduciary duties to Westec requiring professional care," and (2) "engaging in fraudulent acts proscribed by the Securities Act of 1933 and the Securities Exchange Act of 1934."[6]

To further complicate the picture, the court-appointed trustee filed suit against Ernst & Ernst claiming "gross negligence and willful misstatements in certifying the 1964 and 1965 Westec annual reports."[7] However, this action and the stockholder suit have since been consolidated into one action.

A note should be added that for a period of time the Justice Department was considering the filing of criminal indictments against certain members of the Ernst & Ernst partnership. An investigation was undertaken, but no charges resulted. Also, the Securities and Exchange Commission "is considering an administrative proceeding against the firm

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[4] The Wall Street Journal, September 12, 1966, p. 10.

[5] Ibid.

[6] Henry B. Reling and Russel A. Taussig, "Recent Liability Cases--Implications for Accountants," The Journal of Accountancy, CXXX (September, 1970), 50.

[7] The Wall Street Journal, August 22, 1968, p. 26.

under Rule 2-E of the SEC's Rules of Practice."[8] This type of proceeding would not impose any fines or jail sentences, but could result in the refusal to allow certain members of Ernst & Ernst from practicing before the SEC. However, to date no action has been taken by the SEC.

The charges leveled against the auditors by the disgruntled stockholders and security analysts were set out in detail in the literature.

First, it was claimed that Westec's profits were distorted in 1965 and 1966 by the inclusion of several non-earnings items in income. For example, in December, 1965, the parent Westec sold the oil reserves of a subsidiary, WECO, for some $2,300,000 and included the proceeds of its sale in income. The subsidiary drilled about eighty wells in 1965, of which only sixteen were productive. "If these reserves had not been sold, their contribution to earning would have been a small faction of [the $2,300,000]."[9]

Another criticism of Westec's accounting was the inclusion of $1,400,000 in income which represented the proceeds from the sale of oil and gas production payments to an insurance company. Even Ernst & Ernst admitted that "most companies would have given different accounting treatment to the production payments."[10]

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[8] Ibid.

[9] Ibid., p. 32.

[10] Ibid.

They also commented at Westec's 1965 annual meeting that the company's treatment of these production payments "isn't the most predominately used method in the oil and gas industry. . . . The method probably then most used is that of treating it as deferred income."[11] The result of this accounting treatment was to increase 1965 net income by about $1,400,000. The company, in effect, squeezed about five years' income into one year by using this more liberal treatment.

Probably the most controversial complaint against the auditors was the use of retroactive pooling of five newly acquired subsidiaries. The five companies were not formally purchased until 1966; however, under "generally accepted accounting principles" the company could show combined earnings on a retroactive basis in the 1965 financial statements. It should be noted that such practices have always been frowned upon, and the new statements of the Accounting Principles Board of the AICPA now prohibit retroactive pooling when the combination occurs after year end.

A final complaint leveled against the auditors was that certain dealings of Westec did not represent arm's-length transactions. In particular, it was disclosed that a sale of certain producing oil properties to a Wilcrof, Inc. was not a real sale. In fact, it was later learned that certain

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[11] *Ibid.*

officers and stockholders of Wilcrof were related to Ernest Hall, President of Westec, and the sales price of the properties was highly inflated. Another transaction between Westec and Irving Petroleum, which was run by Hall's brother, was found to be a bogus sale.

An article in Forbes[12] accused the directors and officers of Westec and Ernst & Ernst of trying hard to find any type of precedent to support the liberal accounting methods adopted. Regardless of the truth of this statement, the damage to the accounting firm and the company had been done.

While the suit was filed in 1966, there has been no settlement announced at this date. The case is still in the pre-trial stage. This is an excellent example of the protracted legal battle that often follows a suit brought against public accounting firms.

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[12] "What Are Earnings? The Growing Credibility Gap," Forbes, XCIX (May 15, 1967), 30-31.

(18) Douglas Aircraft Company

Ernst & Ernst

Douglas Aircraft Company is a very large California-based aircraft manufacturer. In July, 1966, the company offered for sale $75,000,000 in 4 3/4 per cent convertible subordinated debentures. In connection with this offering, a Registration Statement and Prospectus was filed with the Securities and Exchange Commission. At about the same time as the offering was being successfully made, Douglas was experiencing a major decline in profits. The company experienced a net loss of $16,000,000 for their first nine months of operations in 1966; this was in contrast to a profit of almost $12,000,000 for the same period in 1965. The fiscal third quarter net loss for the period ending August 21, 1966, was $17,000,000 in contrast to a $4,000,000 profit for the same quarter in 1965. The debentures were successfully sold in mid-July, 1966, just two months prior to the announcement of the company's large loss. As a result of the announced losses, the market for all of the company's securities, including the debentures, became depressed.

Several debenture holders filed a suit in U. S. District Court naming Douglas Aircraft, Ernst & Ernst, the company's auditors, and the brokerage firm of Merrill Lynch, Pierce, Fenner & Smith as defendants. The suit alleged "omissions

of fact or inclusion of false statements in the Registration Statement and Prospectus," filed in connection with the debenture offer.[1] More specifically, the debenture holders claimed that Douglas and their auditors did not fully explain the impact of certain changes in accounting for deferred development costs in connection with the DC-9. The direct write-off of certain of these costs contributed to the large net loss. A sentence in the Prospectus stated "it is very likely that net income, if any, for fiscal 1966 will be nominal."[2] The suit alleges that the officers of Douglas and the company's auditor knew at the time the Prospectus was filed that sharply increasing productions costs and changes in accounting procedures would result in a substantial loss for the fiscal year ending November 30, 1966.

No settlement or further action in this case has been mentioned in the literature. It is assumed that the suit is still in the pre-trial stage.

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[1] The New York Times, October 20, 1966, p. 61.

[2] Ibid., p. 63.

(19) Franklin Supply Company

Peat, Marwick, Mitchell & Co.

This is a rather obvious case which was settled quietly and given very little publicity. Franklin Supply entered into negotiations for the purchase of a South American petroleum company, Petroleum Consultants C. A. (Peticon), from its parent, Servicious Hydrocarb. The Caracas office of Peat, Marwick, Mitchell was called upon to perform an audit of Peticon, the results of which would be used as the basis for determining the selling price of the company.

The partner-in-charge of the Caracas office who was also in charge of the audit of Peticon was a former president of the company before going to work for Peat, Marwick, Mitchell. Also, at the time of the audit of Peticon, he was a director of the parent company, Servicious Hydrocarb. Thus, he would be construed by all regulatory agencies and professional societies to have a financial interest in the proposed sale and therefore would not be considered an independent accountant.

After the audit was completed, another firm of public accountants was asked to re-audit the books. They discovered several misstatements and misrepresentations in their second audit.

As a result, Franklin Supply filed suit against Peat, Marwick, Mitchell for breach of the terms of the engagement

and constructive fraud in the audit of Peticon. The court found the auditors guilty, and a settlement in excess of $400,000 was ordered.

The case involved an obvious and flagrant violation of the independence requirements of the American Institute of Certified Public Accountants.

(20) Mill Factors Corporation

Lybrand, Ross Bros. & Montgomery

As its name implied, Mill Factors Corporation was primarily in the business of purchasing accounts receivables at a discount and making the collections on those accounts. The company has been referred to as a "'Tiffany' name among finance companies, a 'Cadillac' of its industry."[1] However, in late 1968, it was revealed that Mill Factors was on the verge of bankruptcy.

Surprisingly, the downfall of the company did not result from its factoring operations, but rather from its commercial finance division. The company was not involved in commercial financing until 1956, when the decision was made to diversify into this area. In this year the decision was made to change the very nature of the company's operations. Instead of the outright purchase of receivables from companies, Mill Factors began to lend money to businesses and accept their receivables as collateral for the loans.

While this move directly involved the company in the financing of businesses, it also became indirectly involved in consumer credit. For it was consumer paper that served as collateral on some of the loans made by Mill Factors.

[1] The New York Times, April 23, 1969, p. 58.

The first awareness of the financial problems at Mill Factors came as a result of a Lybrand, Ross Bros. & Montgomery investigation of the commercial finance division in connection with a possible merger. As a result of their investigation, they reported that of the $43,000,000 in commercial loans examined, the collateral was worth only about $12,000,000. The investigation did not include about $15,000,000 which were thought to be relatively safe loans.

Mill Factors' counsel claimed that the crisis was the result of mismanagement of the commercial finance division.[2] As an example of the ineptness of management, it was pointed out that one loan of $11,000,000, made to Vumeo of Springfield, Massachesetts, exceeded the total capital of Mill Factors reported on the previous year's balance sheet.[3] Further, that the collateral behind this loan was estimated to be worth only about $2,500,000. If, as was the case, this one loan proved worthless, the company would find itself in a financial crisis. Mill Factors' counsel stated that, "you don't get a portfolio of $35 million of doubtful accounts out of a portfolio of $45 million unless somebody poorly managed the extension of credit."[4]

At the time of Lybrand, Ross Bros. & Montgomery's investigation into the commercial loan portfolio of Mill Factors,

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[2] Ibid.

[3] Ibid.

[4] Ibid.

the two senior executives of the division were no longer with the company. One had left to take a position with another company and the other was on sick leave due to a serious illness. This further complicated Lybrand's investigation.

At the time of the announcement of the financial difficulties, company officials hoped to keep several creditors and stockholders from filing damage suits against the company's management and auditors. However, their efforts were in vain as several of the corporation's largest creditors and stockholders filed suit as soon as the seriousness of the possible losses was realized. The suits filed were to recover losses of approximately $35,000,000.

While no statement of the specific charges against the auditors is given in the literature, they can be inferred from the facts presented above and the comments of Phillip L. Defliese, managing partner of Lybrand, Ross Bros. & Montgomery. It seems obvious that the creditors and stockholders claimed that the financial statements attested to by the auditors in 1967 were false and misleading. In particular, they probably claimed that the value of the collateral on certain company loans was inadequate, and the auditors were negligent in not discovering this fact in the course of the audit. Defliese stated that the claims were settled out-of-court because "it would serve no one to get bogged down in litigation extended over many years and centered on a highly technical area of

who bears the respective responsibility--management, auditors or others--in the area of assessing the value of collateral which supports marginal finance loans."[5] This statement would indicate that the question of loan collateral was raised by the creditor group.

On September 23, 1970, a tentative out-of-court agreement was reached between most of the parties involved. A total settlement of $5,950,000 was offered by Lybrand, Ross Bros. & Montgomery and the management of Mill Factors.[6] Of the total settlement, Lybrand, Ross Bros. & Montgomery would pay $4,950,000, and Mill Factors' management group would pay $1,000,000. The settlement has not been finalized because one creditor and a number of stockholders are holding out for a larger settlement. However, it seems likely that the settlement will be accepted by all parties involved. The one hold-out creditor is a relatively small bank, and if it does not accept the offer, Mill Factors will be forced to reorganize under the bankruptcy laws. The proposed settlement would probably yield more to the creditors than a bankruptcy settlement.

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[5] Ibid.

[6] The Wall Street Journal, September 23, 1970, p. 42.

(21) Revenue Properties

Touche, Ross & Co.

Revenue Properties is a Toronto-based real estate development company. In early 1969, it made a public offering of 800,000 shares of common stock. In connection with this offering, the company filed a Registration Statement and Prospectus with the Securities and Exchange Commission and a Prospectus with the Ontario Securities Commission. The issue was successful and the shares were sold to the general public of both the United States and Canada.

Shortly after the sale, the Ontario Commission informed the company that it was using improper accounting for certain sales of land. The Commission requirement stated that income from the sale of development property cannot be recognized until all conditions in the sales agreement have been met. Revenue Properties was recording income at the date of sale. It was necessary for the company to defer about $75,000 in income, which dropped earnings per share from $.65 to $.58.[1] This fact alone is not too important, but an investigation was to go further into the financial dealings of Revenue Properties and its subsidiaries.

In particular, the Commission began to look into certain transactions between Revenue Properties and a subsidiary,

[1] The Wall Street Journal, December 3, 1969, p. 35.

Victoria Wood Development Corporation. Shortly after the new investigation, a suit was filed against the company, its auditors, Touche, Ross & Co., and others. There was no dollar figure set for the amount of damages suffered by Bankers Trust Co. of New York, the plaintiff in the suit.

There were two major allegations in the suit: first, that certain directors and officers, who owned about ten per cent of the outstanding stock, had sold their shares to the general public about three months before the registration statement became effective.[2] In effect these individuals were selling unregistered securities to the public in violation of SEC regulations. The second charge was that a number of land transactions were recorded as "sales" and the sales price taken into income, when the purchasers were in fact Revenue Properties or its subsidiary, Victoria Wood Development Corp. If true, these sales would not be considered bona fide transactions. Based on their allegations, Bankers Trust claimed the Prospectus and Registration Statement, for the sale of the company's common stock, contained "untrue statements and omitted material facts."[3]

Shortly after this suit was filed, the company's auditors, Touche, Ross & Co., asked to withdraw from the audit engagement. They had discovered that one of their partners had accepted a

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[2] Ibid.

[3] Ibid.

loan of $12,500 from an officer of Revenue Properties. The partner used the proceeds from the loan to buy stock in Victoria Wood Development Corp. The loan had been repaid to the officer. However, there is no doubt that this is a violation of the rules of independence by all professional societies and certain governmental regulatory agencies.

Another suit has been filed against the company, Touche, Ross & Co., and others by U. S. Trust Company claiming that it had been a purchaser of the unregistered securities and had not known the status of the stock when it was purchased.[4]

There has been no announcement of a settlement in this case. It is probable that the various lawsuits will be consolidated. The case is in the pre-trial stage.

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[4]The Wall Street Journal, April 2, 1970, p. 33.

(22) Standard Kollsman

Price Waterhouse & Co.

Standard Kollsman is a diversified manufacturer of electrical and electronic components. The company is well establised and respected in its industry. Based on available facts, it was learned that the company has been involved in a number of recent lawsuits that appear to be connected with certain merger arrangements.

One suit of particular interest was brought by Sun Chemical Company and alleged that Standard Kollsman's 1969 financial statements were false and misleading. The suit claimed that the financial statements overstated the company's earnings "and had the effect of artificially inflating the market price" of the company's stock.[1]

Prior to the time the suit was filed Sun Chemical was considering the purchase of Standard Kollsman through the purchase, on the open market, of a substantial portion of their outstanding stock. In 1968, Sun Chemical purchased 220,000 shares of the company's stock at a price ranging from $21.00 to $31.00 per share. For the year 1969, Standard Kollsman reported a loss of about $400,000. As a result of the company's poor earnings, its stock dropped to about $14.00 per share.

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[1] _The Wall Street Journal_, September 3, 1969, p. 7.

Sun Chemical Company claims that it had suffered a loss of $1,500,000 in the stock purchase. It further stated that the original purchase of 220,000 shares was based upon Standard Kollsman's own estimate that 1969 earnings would be $1.16 per share. At this point, Sun Chemical announced that it no longer planned to purchase Standard Kollsman.

However, in early 1970, it was learned that Sun Chemical was proceeding with its original plan and had purchased another large block of Standard Kollsman's stock.[2] Finally, in April, 1970, Sun Chemical announced that it was dropping all charges against the company and its auditors.[3]

To further complicate an already clouded case, another company, Sundstrand, interested in the purchase of Standard Kollsman, filed suit against the company. Sundstrand claimed the company "fraudulently induced it to buy 3,190 shares early in 1970 when the two concerns were holding merger talks that were subsequently ended."[4]

No settlement has been announced in this second suit; however, circumstances would indicate that the suit is probably groundless, as the Sun Chemical suit appeared. This does not, however, eradicate the adverse publicity received by the company's auditors.

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[2] The Wall Street Journal, January 9, 1969, p. 18.

[3] Chicago Daily News, April 12, 1970, p. 26.

[4] The Wall Street Journal, September 3, 1969, p. 7.

(23) R. Hoe & Company

Lybrand, Ross Bros. & Montgomery

R. Hoe & Co. is an old and well-established manufacturer of printing presses and circular saws. The company, which had been in business for 164 years, petitioned for a reorganization in 1969 under Chapter X of the National Bankruptcy Act. Under Chapter X, the company would be placed under the control of a court-appointed trustee, who would then dispose of Hoe's assets and use the proceeds to pay the company's creditors.

The exact causes of the company's financial problems are extremely difficult to discern from the literature. For several years prior to 1964, the company had been struggling to show a profit. In fact, for the fiscal year ended September 30, 1963, Hoe reported a net loss of about $312,000. However, between 1963 and 1967, Hoe's fortunes reversed, and the company reported a record profit of $2,400,000 for the 1967 fiscal year.

The company's common shares, "which had sunk to as low as $.41 in 1963, shot as high as $59.625 (in 1968), although no cash dividends had been paid since 1956."[1] Mutual funds became heavy buyers of the company's common stock. Just prior to its financial collapse, it was reported that mutual funds had

[1] The Wall Street Journal, July 3, 1969, p. 4.

acquired over 40 per cent of the company's outstanding common stock.[2] The stock was held in good standing on Wall Street. "Market analysts were predicting a new record for fiscal 1968. Sales had soared from $16.9 million in 1963 to $46.1 in fiscal 1967."[3] It had been predicted that 1968 sales would reach about $60,000,000.

However, profits for 1968 only reached $2,100,000 after nine-month profits had previously been reported at $2,900,000. The bad news continued. "For the six months ended March 31, (1969), Hoe's net loss was $1.2 million, contrasted with a $1.8 million profit the year before. Sales skidded to $16.1 million from $31 million in the first half of 1968."[4] With this announcement, the company's stock fell dramatically.

The announcement of Hoe's financial difficulties was made on January 23, 1969. Just two days prior to the announcement, the company's President, Arthur Gordon, resigned stating that his wife had become critically ill. Gordon had assumed his position nine months earlier when Thomas Hanley resigned from the company. A long-time friend of Hanley's and director of Hoe also resigned two days prior to the announcement. In February, 1968, yet another director resigned in a dispute over operating and financial policies.[5]

A total of six lawsuits have been filed against the Directors and Officers of Hoe, the company's independent

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[2]*Ibid.* [3]*Ibid.*

[4]*Ibid.* [5]*Ibid.*

account, Lybrand, Ross Bros. & Montgomery, and the brokerage firm of Blair & Co., Inc. The suits against the directors and officers claim that they used "inside" information to sell their stock holdings prior to the announcement of January 23.

In a request by Lybrand, Ross Bros. & Montgomery to consolidate four of these suits, District Judge Lasher stated "the principal issue of law and fact in each of the cases are identical; the alleged publication by Hoe of its Annual Report for the fiscal year ended September 30, 1967, and interim financial statements thereafter, all of which are claimed to have contained false and misleading statements of material facts as to Hoe's financial status and operations."[6] Further in his statement he explained that "each complaint contends that Hoe understated its tax liabilities and operating costs, while overstating its sales revenues and cash position."[7]

Hanley, a former President and Chairman of Hoe, blamed much of the company's financial difficulty on certain special charges requested by Lybrand, Ross Bros. & Montgomery in the course of their 1968 audit. The company had originally planned to charge about $1,000,000 of development and improvement costs to income over a period of years. However, Lybrand

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[6] Feldman v. Hanley, Federal Securities Law Reporter, p. 98, 320.

[7] Ibid.

urged that the full amount be written off in fiscal 1968.[8] In addition, the company wrote off a $700,000 reserve for possible increased production costs in fiscal 1968.

Little detail is available on the specific charges in these cases, as the cases have yet to go to trial. However, it is known that one suit claims that Hoe "improperly allocated to sales some portion of its production for which no firm orders had been received."[9]

No disposition of the suits has yet been made.

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[8] The Wall Street Journal, op. cit.

[9] Ibid.

(24) Blair & Company

Arthur Young & Company

Blair & Company is a brokerage firm and member of the New York Stock Exchange. In late 1969, the firm became financially distressed, and in early 1970, the New York Stock Exchange began liquidating the firm. It is common practice for the Exchange to assist financially distressed brokerage firms by advancing them money from a special trust fund. However, in September, 1970, four of Blair's creditors filed suit to block the Exchange's assistance and forced the firm into voluntary bankruptcy.

The creditors' suit claimed that they were induced to make loans to Blair & Company on the basis of its recent public financial statements and that these statements were false and misleading. The suit is very explicit in its charges against the firm and their auditors. They claim that the directors and officers of Blair & Company "committed a number of fraudulent acts in soliciting the loans (from them)."[1]

First, they charged that at the time they made the loans to Blair & Company, they were told that no material withdrawals of other loans were being made. However, the creditors pointed out in their charges that between August, 1969, and March, 1970,

[1] The Wall Street Journal, October 1, 1970, p. 8.

about $6,000,000 worth of loans had been withdrawn.[2] About 75 per cent of the withdrawals came within two months after the creditors' loans were made. A further charge was that during the loan negotiations, one of Blair's creditors was demanding the return of $1,000,000 in subordinated securities deposits, and this fact was never revealed.

In addition, the suit claimed that during the loan negotiations "Blair was in violation of the capital account requirements of all the stock exchanges to which it belonged and was also in violation of the capital requirements fixed by various Governmental agencies,"[3] and they were told that the loan from these creditors would "allow Blair to continue in compliance with standards on capital requirements."[4]

One final and significant charge was that the Chairman of Blair made about $2,000,000 in securities available to the firm with the understanding that the securities would be withdrawn as soon as the loan was made.

The primary charge against the auditors, Arthur Young & Company, was that none of these material facts were revealed in the audited financial statements. The creditors also claim that the auditors were aware of certain substantial errors in the books of Blair and warned the firm of its weak accounting system, and this knowledge was not made available to them.

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[2] Ibid.

[3] Ibid.

[4] Ibid.

Two days after the creditor suit was brought against Blair and Arthur Young & Company, the Securities and Exchange filed injunctions against the Chairman of Blair and three other individuals "barring them from violations of registration and anti-fraud provisions of Federal securities laws."[5] The SEC claimed that the four men sold securities that had not been registered with them.

The creditor suit seeks damages of $9,000,000 and the SEC suit has the effect of preventing Blair from trading in securities until the injunction is lifted.

As the suit has just recently been filed, it is too early to speculate about the eventual outcome of the case.

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[5]The Wall Street Journal, October 2, 1970, p. 29.

(25) Liberty Equities Corporation

Peat, Marwick, Mitchell & Co.

Until 1970, Liberty Equities was a relatively small but rapidly growing conglomerate. Its Board of Directors and management included many well-known Washington D. C. personalities.

However, in August 1970, the Securities and Exchange Commission sought an injunction in Federal District Court to prevent certain officials of Liberty Equities, its bank, underwriters and independent accountants, Peat, Marwick, Mitchell from further violation of the 1934 Securities Exchange Act. The charge stated that the company and a group of its officials "made false and misleading statements to the SEC, company stockholders and the general public about its financial condition and operations."[1] The complaint went on to charge the officials and others with "falsifying financial statements, distributing unregistered stock and manipulating the market of the stock."[2]

The specifics of the charges revolve around certain transactions that the SEC considered to be mere "window dressing." The SEC claimed that Liberty Equities borrowed $325,000 at year-end to "dress-up" the balance sheet. The

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[1] Washington Post, August 7, 1970, Sec. C, p. 4.

[2] Ibid.

proceeds of the loan were put into non-interest bearing certificates of deposit which served as collateral. The note payable, which was four fourteen months, was classified as a long-term liability. The effect of this transaction was to improve the company's current ratio. It was claimed that the accountants failed to disclose the fact that the certificates of deposit were non-interest bearing and that these certificates were being used as collateral for the fourteen-month loan.

The second major charge claimed that the company included in "ordinary" income the profit of $760,000 that resulted from the sale of an option on real estate property. The option was purchased for some $45,000 and sold for $808,000 on the last day of Liberty Equities' fiscal year.

In November, 1970, the court issued an injunction against Liberty Equities and its bank, enjoining them from "future violations of the anti-fraud provisions of SEC acts."[3] The action against Peat, Marwick, Mitchell is still pending. This case is unusual in the respect that, to date, there have been no stockholder or other third party suits against any of the defendants named in the SEC action. The only claim filed was that of the SEC. It is reasonable to assume that, as a result of the court injunction, some third party suits are likely to develop.

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[3]*The Wall Street Journal*, November 10, 1970, p. 16.

The Wall Street Journal summarized the accounting aspects of the case by stating that "further action in the case could bear on the current controversy over whether accounting firms exercise enough independent judgment in auditing the books of publicly-held corporations."[4] The primary issue in the case is whether the accounting firm of Peat, Marwick, Mitchell will be allowed to continue to practice before the SEC as an independent accountant if in fact they have been found to lack independence in this particular case.

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[4] *Ibid.*

APPENDIX B

INTERVIEW FORMAT

Name: ______________________________

Firm: ______________________________

Date: ______________________________

The purpose of this interview is to collect information about risk evaluation in public accounting practice. For purposes of this interview the term risk is defined as the probability that a particular audit engagement will eventually result in some damage to the reputation of an accounting firm. This is the same risk faced by all professional groups.

1. May I have permission to use your name or the name of your firm in connection with this study?

   Yes_____ No_____

2. Reactions of the interviewee to the definition of risk. General Comments: ______________________________

   ______________________________.

   No Comments: __________

3. In light of the above definition of risk (that is, the probability that an audit engagement will result in damage to a firm's reputation) are there any types of audits that you would consider to be high risk audits, and what makes them risky?

Type of Audit	Reasons	Additional Comments

4. Prior to each NEW engagement (as distinguished from a repeat engagement) does your firm explicitly consider the relative risk involved? Do you have a formalized program for risk evaluation? May I have a copy of the program?

   Explicit? Yes________ No________
   Formalized? Yes________ No________
   Program? Yes________ No________

   General Comments:

5. Is the relative risk considered informally?
   Yes______ No_______

   How is the evaluation of risk conducted? What are the factors you consider when evaluating risk?

   General Comments:

Factors	Comments
____________________	____________________________________
____________________	____________________________________
____________________	____________________________________

6. What do you consider a good working definition of internal control?

   ____

   ____

   ____

   ____

7. Does your firm maintain a standard questionnaire for the evaluation of a client's system of internal control, or does the questionnaire vary from audit to audit?

Standard______ Flexible______

STANDARD QUESTIONNAIRE:

(a) Who actually evaluates the internal control?

(b) May I have a copy of the standard questionnaire used?

Yes______ No______

(c) Has the questionnaire significantly changed in the past 10-15 years. What has been the cause of the change?

Change	Cause
____________________	____________________
____________________	____________________
____________________	____________________

No Change______

FLEXIBLE QUESTIONNAIRE:

(a) How is the questionnaire developed for a particular audit?

(b) What factors or variables are considered before the questionnaire is drawn up?

1.
2.
3.
4.
5.

(c) What factors cause the questionnaire to change from audit to audit?

Factors	Comments
____________________	____________________
____________________	____________________
____________________	____________________

8. What factors influence your decision to refuse either a new or repeat engagement?

Factor	Comments
____________________	____________________________
____________________	____________________________
____________________	____________________________
____________________	____________________________

9. Does your firm have a working paper review program or some other method of auditing the auditors?

Yes_____ No_____

How does the program operate?

What are the most common problem-areas mentioned in the reports of your reviewers?
1.
2.
3.
4.
5.

If the review is formalized, may I have a copy of the program or procedures followed?

Yes_____ No_____

10. Does your firm maintain a program or questionnaire or some other formalized procedures for the evaluation of a client's management?

Yes_____ No_____

May I have a copy of the procedures?

Yes_____ No_____

11. If the evaluation process is informal, what steps are taken to determine the reputation of management?

Steps	Comments
______________	______________
______________	______________
______________	______________
______________	______________

12. How would you characterize your firm's method and rate of growth in the past 10-15 years?

How would you characterize the rate of growth of your management services department in the same time period?

13. What types of management services do you perform?
1.
2.
3.
4.
5.
6.
7.
8.
9.
10.

Do you think it impairs independence to perform management services and audits at the same time? Why or why not?

Yes_____ No_____

Reasons

Do you think that the following factors influence the risk associated with a new audit engagement? If yes, how do they influence the risk? If no, why not?

1. Client's rate of growth Yes____ No_____ Could____
   Comments

2. Nature of client's business Yes____ No_____ Could____
   Comments

3. Type of financing used by client Yes____ No____ Could____
   Comments

4. Reputation and stability of client's management
   Yes____ No____ Could____
   Comments

5. Client's system of internal control Yes____ No____ Could____
   Comments

6. Independence of auditor Yes____ No____ Could____
   Comments

For repeat engagements does the Longevity of the Engagement influence the auditor's relative risk?

Yes____ No_____ Could____

Comments

Are there any other factors that you think influence the relative risk of a new or repeat engagement?

Factors	Comments
______________________	______________________________
______________________	______________________________
______________________	______________________________
______________________	______________________________

Do you think that the risk is higher for new or repeat engagement? Why?

New_____ Repeat_____

Comments

If you were trying to evaluate the risk associated with a given audit engagement and information was available on all of the following areas of the client's business, how would you rate the importance of knowing such information? You may delete or add any other areas that would be of interest to you.

_____ Client's rate of growth

_____ Nature of client's business

_____ Type of financing used by client

_____ Reputation and stability of client's management

_____ Client's system of internal control

_____ Other (specify and rank)

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