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THE LOUISIANA STATE UNIVERSITY AND AGRICULTURAL AND MECHANICAL COL., PH.D., 1978

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AN INQUIRY CONCERNING THE SELECTION, ROTATION, AND RETENTION OF INDEPENDENT AUDITORS

A Dissertation

Submitted to the Graduate Faculty of the
Louisiana State University and
Agricultural and Mechanical College
in partial fulfillment of the
requirements for the degree of
Doctor of Philosophy

in

The Department of Accounting

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ABSTRACT

The accounting profession as a whole has been receiving more and more attention from several sectors of the business environment, including the Securities and Exchange Commission and the government. This attention has been directed toward a study of the accounting practices of publicly owned corporations and their auditors by the United States Senate Subcommittee on Reports, Accounting and Management. This study and other inquiries into the practices of the accounting profession are indicative of the need for the accounting profession to consider possible areas of self regulation. The area which is being explored here is the selection, rotation and retention of independent auditors. Accordingly, the objectives of this study are threefold: (1) to examine the advantages and disadvantages of the rotation of auditors, (2) to survey accountants in public practice and controllers in industry for their opinions on a policy of rotation of auditors, and (3) to examine the results of the survey and determine whether or not the accounting profession should adopt a policy which requires rotation of auditors.

This study began by examining the advantages and disadvantages of rotation of auditors through a study of

material previously published, thereby accomplishing objective one. The advantages of rotation which were discussed include the maintenance of independence, the securing of a fresh point of view and the possible reduction of litigation against accountants. The disadvantages, which were discussed, include the loss of large clients by CPA firms, the adverse effects of installing new auditors, the experience and information loss from previous audits, and the disruption of types of services offered to the client.

A questionnaire was sent to practicing accountants and controllers for their opinions, thereby accomplishing the second objective. The questionnaire, which explored the practices of selecting, rotating, and retaining independent auditors, was sent to the controllers of the Fortune 500 companies and to a select group of CPA firms. The CPA firms included the firms in the group known as the "Big 8" and "Big 7" firms. Responses from the controllers totaled 339, for a 67.8% response rate. Responses from the CPA firms totaled 10, for a 66.67% response rate. A policy of automatically changing independent auditing firms on a routine basis was not favored by 322 of the controller respondents (96.12%). The CPA respondents who did not feel that the future would hold a policy of compulsory rotation of CPA firms among clients totaled 8 (80%).

The results of the survey in this study indicated that the accounting profession and the business sector do not favor any changes in the policies governing the

selection, rotation and retention of independent auditors. However, this writer feels that it would be better for the accounting profession to implement a policy of rotation of auditing firms among clients voluntarily rather than have such a policy imposed upon the profession by an outside agency, be it the United States Congress or the Securities and Exchange Commission.

Chapter 1

INTRODUCTION

The accounting profession as a whole has been receiving more and more attention from several sectors of the business environment, including the Securities and Exchange Commission and the government. This attention has been directed toward a study of the accounting practices of publicly owned corporations and their auditors by the United States Senate Subcommittee on Reports, Accounting and Management. The results of this study, known as _The Accounting Establishment_, and other inquiries into the practices of the accounting profession are indicative of the need for the accounting profession to consider possible areas of self regulation. The area which is being explored here is the selection, rotation and retention of independent auditors.

Reliance of Businesses on Accountants

For years the accounting profession has been growing at a rapid pace. The amount of work carried out by accounting firms has increased significantly over the past ten years. As businesses grow from small concerns to multilevel organizations, their need for competent accountants grows also. Once a business firm establishes a working

relationship with a competent accounting firm, the tendency is for that business to continue the good relationship as long as possible. Accountants also lean toward maintaining the relationship with good, longstanding clients.

On the surface, there is nothing wrong with the building up and maintaining of good, successful business relationships between clients and accountants. However, over a period of time, it may become evident that management is exercising some influence over the independent accountant's audit procedure. This might tend to reduce the auditor's degree of independence and his objectivity.

Company Formation of an Audit Committee

An accountant is generally engaged to examine the financial statements of a company and issue an objective opinion on those statements. The board of directors of any company places heavy emphasis on the statements and accompanying opinion of the outside auditor. As the directors of the company receive more pressure from the company stockholders to examine management's activities and safeguard the company assets, the board of directors in turn looks to the outside, independent auditor for help in examining the financial statements and consequently, the activities of management.

To enable the board of directors to better understand the function of an independent outside auditor and the work which he performs for the company, many companies

have established what is known as an audit committee. Audit committees help directors of a company to examine closely the audit function and to understand the importance of an independent audit. Directors become more aware of the difference between management, which operates the business, and the board of directors, which checks on management and determines broad policy.

The use of an audit committee to better serve the interests of companies and their stockholders has received considerable attention. In January of 1977, the New York Stock Exchange issued an "Audit Committee Policy Statement" in which a definite date was set for the formulation of an audit committee by each domestic company listing common shares of stock on the New York Stock Exchange. The audit committee must be formed no later than June 30, 1978.[1]

Audit committees mainly do two things. The first responsibility is to examine the outside auditor's management letter. The second responsibility is to appoint the independent auditor for the firm. New members of audit committees frequently find that once this second responsibility is carried out, there is opposition to changing the appointed outside auditor. The question arises as to why this should be the case. Do companies want long, continuing management-

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[1]R. K. Mautz and F. L. Neumann, Corporate Audit Committees: Policies and Practices (Altamonte Springs, Florida: The Institute of Internal Auditors, Inc., 1977), p. 19.

auditor relationships in order to influence the auditor? Or are companies opposed to changing auditors for other reasons?[2]

The interests of the stockholders, which the board of directors is elected to protect, is best served by the examination of the statements by a completely independent auditor. Some companies are therefore considering the question of adopting a policy of rotating the Certified Public Accounting firms which serve them as independent auditors.[3] Such a policy could affect the accounting profession considerably. Rather than leaving the adoption of such a policy to industry, which auditors serve, it would appear to be better to have the accounting profession investigate the need for the rotation of auditors.

SEC Practice Section of the AICPA

The American Institute of Certified Public Accountants has addressed itself to the problem of improving the practice of accounting before the Securities and Exchange Commission. In September of 1977, the Council of the AICPA adopted a resolution which established a new division of the AICPA. The division is composed of a "SEC Practice Section" and a "Private Companies Practice Section." Both of these sections have similar objectives.

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[2]Robert K. Mautz, "Rotation of Auditors," *Financial Executive*, Vol. 42 (July, 1974), pp. 48-49.

[3]*Ibid*.

The SEC Practice Section has set forth the following four objectives:

1. Improve the quality of practice by CPA firms before the SEC through the establishment of practice requirements for member firms.
2. Establish and maintain an effective system of self-regulation of member firms by means of mandatory peer reviews, required maintenance of appropriate quality controls and the imposition of sanctions for failure to meet membership requirements.
3. Enhance the effectiveness of the section's regulatory system through the monitoring and evaluation activities of an independent oversight board composed of public members.
4. Provide a forum for development of technical information relating to SEC practice.[4]

Several requirements for membership of CPA firms in the SEC practice division were set forth by the AICPA. The following requirement ties in closely with the second objective stated above which calls for an effective system of self-regulation:

> Assign a new audit partner to be in charge of each SEC engagement which has had another audit partner in charge for a period of five consecutive years and prohibit such incumbent partner from returning to in charge status on the engagement for a minimum of two years. . . .[5]

This requirement establishes a policy of mandatory rotation of the audit partners which is one step toward a form of self-regulation. However, it is possible that the accounting profession should go further in the area of

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[4]"The AICPA Division of CPA Firms," The Journal of Accountancy, Vol. 144 (November, 1977), p. 113.

[5]Ibid.

self-regulation. The profession should examine whether or not the rotation of auditors, that is, audit firms, should be adopted within the accounting profession as a whole.

The Nature of the Problem

The overall problem of this study is to determine whether or not a policy of rotation of auditors should be considered by the accounting profession as a whole. The questions which immediately arise are primarily the following:

1. What are the advantages of rotating auditors?
2. What are the disadvantages of rotating auditors?

These two areas are explored and discussed through a review of the professional literature. In addition, a questionnaire, to be explained later, presents the opinions of controllers and CPAs regarding the selection, rotation and retention of independent auditors.

If some companies feel that accountants are compromising their professional standing by maintaining long-standing relationships with clients, then it is necessary to look at a way to re-establish the outside auditor as a completely independent examiner of financial statements.

The Scope of This Study

This study is oriented toward the accounting profession as a whole within the United States. Practical

considerations necessitated the restrictions placed on the scope of this study.

Limitations of the Study

This study is limited to gathering the opinions of the controllers of the five hundred largest industrial companies in the United States and a select group of CPA firms. In order to determine whether or not there should be a policy regarding rotation of auditors, it is necessary to question those persons in industry who deal with auditors as well as the auditors themselves.

The field of empirical research has been limited to the controllers of the five hundred largest industrial companies on the basis that they represent the largest businesses in the United States. In addition, it is their close associations with independent accountants which give rise to concern by third parties over their possible influence over independent auditors. These five hundred companies collectively are in a good position to exert influence from the business sector over the general practices and procedures of the accounting profession as a whole. A previous study of auditor changes done by John C. Burton and William Roberts explained their use of the <u>Fortune</u>'s 500 list as follows:

> <u>Fortune</u>'s 500 list was used because it included the bulk of the unregulated large corporations which require auditor's opinions. We felt that large firms were crucial in considering the public

> interest associated with the attest function, both because they control a substantial proportion of the country's resources and because their economic power over public accounting firms is potentially the greatest.[6]

The second group of opinions is gathered from a small group of CPA firms known as the "Big 8" and the "Big 7." According to the Senate Subcommittee on Reports, Accounting and Management, the "Big 8" firms are very powerful and influential. The "Big 7" are also important but not nearly as large. The report of the subcommittee stated the following:

> These eight firms are so big and influential in relation to other accounting firms that they dominate the practice of accounting in the United States and probably throughout the world.
>
> . . . .
>
> The influence exercised by the "Big 8" firms far exceeds that which might be expected from the number of CPAs working for them. Only about 11 or 12 percent of the nation's estimated 160,000 CPAs are associated with "Big 8" firms, but their influence is magnified because their clients are the largest and wealthiest corporations in the United States. Because of their large size, the "Big 8" firms exercise substantial influence directly on accounting practices promulgated or approved by the Federal Government. They also exercise substantial indirect influence through the American Institute of Certified Public Accountants (AICPA), which they control, and through the accounting practices followed by their corporate clients.[7]

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[6]John C. Burton and William Roberts, "A Study of Auditor Changes," The Journal of Accountancy, Vol. 123 (April, 1967), p. 32.

[7]U. S., Congress, Senate, Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, The Accounting Establishment: A Staff Report, S. Doc. No. 95-34, 95th Congress, 1st Session, 1977 (Washington, D. C.: Government Printing Office, 1977), pp. 4-5.

In selecting the controllers of the five hundred largest industrial companies and the "Big 8" and "Big 7" firms, the results of the survey reflect the opinions of the persons who use the largest auditing firms as well as the opinions of those who perform the work. Of the 500 companies surveyed, 495 or 99% of them are audited by the "Big 8" and the "Big 7" CPA firms.

Limitations of a Questionnaire

The questionnaire distributed in this study is subject of the limitations inherent in the questionnaire technique. Such limits include the interpretation of questions differently by respondents, the confusion over terminology used and the possible result of a poor response rate. The advantages of a questionnaire are twofold. It allows a researchers to contact persons over a large geographical area. In addition, the questionnaire allows a respondent to reply to the questions at his own convenience.

Objectives of This Study

The objectives of this study are threefold:

1. To examine the advantages and disadvantages of the rotation of auditors.
2. To survey accountants in public practice and controllers in industry for their opinions on a policy of rotation of auditors, and

3. To examine the results of the survey and determine whether or not the accounting profession should adopt a policy which requires rotation of auditors.

The accounting profession is constantly growing and changing, as is the overall size of industry. As a result of the increasing size of business and the greater need for audits performed by certified public accountants, the pressures felt by accountants have increased. It may therefore be necessary to consider the adoption of a policy within the accounting profession regarding the rotation of auditors among companies. This study is aimed at helping the accounting profession decide whether a policy of rotation of auditors is needed.

Research Methodology

This study begins to look at the subject of rotation of auditors by examining the advantages and disadvantages of such a policy. By studying the advantages and disadvantages, a more thorough understanding of what such a policy means was made clear. This first objective was accomplished by examining material already published. The results of this research are presented in Chapters 2 and 3.

In preparation for achieving the second objective of surveying accountants and controllers for their opinions, a questionnaire was formulated for each group which explored the practices of selecting, rotating, and retaining

independent auditors. In addition, the questionnaires asked for opinions as to whether a policy of rotation of auditors should be adopted by the accounting profession. The questionnaires were submitted to the controllers of the Fortune 500 companies and to a select group of CPA firms to obtain their opinions. The questionnaires along with the transmittal letters are presented in Appendix A.

The questionnaire for the controllers was sent to each of the controllers of the companies included in the Fortune's 500 grouping. A list of these companies is presented in Appendix B. The questionnaire was mailed March 1, 1978. All useable responses received on or before March 31, 1978, were included in the results which were processed by a computer program. The total responses were 339; the response rate was 67.8%. Of these 339 responses, 335 were useable. Four respondents stated an inability to participate in the survey.

The questionnaire for the CPA firms was sent to a partner in charge in the home office of each of the "Big 8" and "Big 7" firms. The firms in the "Big 8" grouping are as follows:

Arthur Andersen and Company

Arthur Young and Company

Coopers and Lybrand

Ernst and Ernst

Haskins and Sells

Peat, Marwick and Mitchell and Company

Price Waterhouse

Touche Ross and Company.

The firms that compose the "Big 7" group are as follows:

Alexander Grant and Company

Hurdman and Cranstoun

J. K. Lasser and Company

Laventhol and Horwath

S. D. Leidesdorf and Company

Main Lafrentz and Company

Seidman and Seidman.

The questionnaire was mailed March 10, 1978. A follow-up questionnaire was mailed April 24, 1978. All useable responses received on or before May 24, 1978, were included in the results which were tabulated by the researcher. The total responses were 10; the response rate was 66.67%. The results of both questionnaires are presented in Chapter 4.

Preview to This Study

In Chapter 2 the various advantages of a policy of rotating auditors are discussed. The disadvantages of a policy of rotating auditors are discussed in Chapter 3. A questionnaire exploring the selection, rotation and retention of independent auditors was submitted to both industrial firms and CPA firms. The results of these questionnaires are presented in Chapter 4. Summary and concluding remarks are presented in Chapter 5. Appendix A contains

the questionnaires and transmittal letters. Appendix B contains the list of the *Fortune* 500 companies to which the questionnaire for the controllers was sent.

Chapter 2

THE ADVANTAGES OF THE ROTATION OF AUDITORS

When considering a policy such as rotation of auditors, it is necessary to understand, discuss, and question the advantages and disadvantages of such a policy. In this chapter, the advantages of rotation of auditors will be explored. What exactly would be considered the benefits of a policy of rotation of auditors?

The advantages of a policy of rotation of auditors are as follows:

1. Maintenance of independence,
2. Presenting the client with a fresh point of view, and
3. Possibly reducing litigation against accountants.

Each of these advantages is discussed in this chapter.

Maintaining Independence

The first and most often discussed advantage of rotating auditors is the maintenance of independence. Not only the maintaining of independence, but the strengthening of independence is viewed as a primary benefit of rotation

of auditors. Why is this so? Why is independence so important?

Independence is considered to be the cornerstrone of the accounting profession. The reason is that people, that is, third parties, look to accountants to issue opinions that are fair and unbiased with regard to the financial statements of a company. Accountants, specifically auditors, cannot do that unless they are independent.

What Does It Mean to be Independent?

Webster's Dictionary defines independence as "the quality or state of being independent" and independence as "not subject to control by others; self-governing."[1] How do others view independence?

Independence as Viewed by the AICPA

The American Institute of Certified Public Accountants has issued a Code of Professional Ethics which guides certified public accountants in their professional conduct. The Code of Professional Ethics helps accountants to govern themselves. The AICPA has an Auditing Standards Executive Committee which issues Statements on Auditing Standards. These auditing standards are adhered to by certified public accountants. The AICPA's primary set of standards are known

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[1] *Webster's Seventh New Collegiate Dictionary* (Springfield, Mass: G. and C. Merriam Co., 1963), p. 426.

as generally accepted auditing standards and are composed of general standards, standards of field work and standards of reporting. Of the general standards, the second one is perhaps the most important. It is as follows:

> In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.[2]

The AICPA does on to describe what is meant by this general standard on independence.

> This standard requires that the auditor be independent, aside from being in public practice (as distinct from being in private practice), he must be without bias with respect to the client under audit, since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. However, independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.[3]

The discussion of this standard continues by emphasizing the need for the public to remain confident in the auditor's independence. The profession's code of ethics contains precepts which guard against any assumption of the loss of independence by an auditor. Basically, the AICPA views independence in the following manner:

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[2]American Institute of Certified Public Accountants, <u>Statement on Auditing Standards: Codification of Auditing Standards and Procedures</u> (New York: American Institute of Certified Public Accountants, 1973), p. 5.

[3]<u>Ibid</u>., pp. 8-9.

> To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners. . . . Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.[4]

Having reviewed the AICPA standard regarding independence, it is useful to look at other meanings and interpretations of independence as it relates to accountants in order to understand more fully why accountants place so much importance on this one facet of professional conduct.

Independence as Viewed by Third Parties

It is interesting to take an historical look at how the public--that is, third parties--have perceived accountants and independence over the years. Third parties are defined, for the purposes of this discussion, as those people who are "providing or using relevant, timely and verifiable information which is free from bias, but who are not acting as spokesman for the AICPA or the Securities and Exchange Commission."[5]

The viewpoint of third parties can be segmented into three periods of time. The first era is the pre-World War I time period. During this period, detection of fruad was the primary purpose of the nineteenth century auditor.

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[4] Ibid.

[5] Robert E. Schlosser, "An Historical Approach to the Concept of Independence," The New York Certified Public Accountant, Vol. 39 (July, 1969), p. 522.

Independence was conceived as denoting "disinterestedness" or "outsiderness." This was all that was necessary to detect fraud. In the early 1900's, the idea of independence in fact began to develop. If an auditor was independent, it was necessary for him to have integrity, honesty, and freedom to express his opinion when certifying a company's financial statements. Without the integrity and honesty, the presence of independence meant nothing to third parties.[6]

The second era of the public viewpoint of independence is marked by the years from World War I to the Depression. During this era the idea of independence meaning integrity and honesty grew. Detection of fraud was still considered the main purpose of an audit. However, in the early 1930's, an article in the Journal of Accountancy talked about the fact that since railroads were audited by the Interstate Commerce Commission, it was not usual for them to use independent audits. However, the underlying idea expressed in the article was that an auditor's independence guaranteed honesty and integrity which was needed to make audits of value and full compliance was supported. Independence is now developed to mean having integrity and honesty, not only "disinterestedness."[7]

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[6] Ibid., pp. 522-523.

[7] Ibid.

The third era takes up the period of the Post Depression years. There were two significant developments which occurred in the early 1930's. First, the Securities Act of 1933 and Securities Exchange Act of 1934 stated requirements for independent auditors. Second, the New York Stock Exchange called for independent audits of all companies listed on the exchange. These two events put new pressures on public accountants. They now had to compose generally accepted accounting principles to which the New York Stock Exchange companies should conform. Here the concept of independence for an auditor takes on the aspect of someone who can objectively apply accounting principles as well as detect fraud.[8]

With the formulation of the generally accepted accounting principles, the auditor now is responsible for passing judgment on the application of principles to a company's statements. This can be called the "objective judgment" criteria of independence. Independence now means having the ability and willingness to be objective in passing judgment on the satisfactory application of generally accepted accounting principles, besides being honest and having integrity. The "objective judgment" criteria of independence which developed during the Post Depression

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[8] *Ibid.*, p. 524.

years is very close to the concept of independence as a "state of mind" which is widely held today.[9]

Independence as Viewed by the Securities and Exchange Commission

Regulation S-X of the Securities and Exchange Commission Accounting Rules is the principal accounting regulation. Within this regulation Rule 2.01 sets forth the Securities and Exchange Commission's formal requirements as to the qualifications of accountants and their independence. Rule 2.01 is as follows:

> (a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.
>
> (b) 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 or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he or his firm or a member thereof had, or was committed to acquire, any direct financial interest or any material indirect financial interest; (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period covered by the financial statements, he or his firm or a member thereof was

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[9] *Ibid.*

> connected as a promoter, underwriter, voting trustee, director, officer, or employee, except that a firm will not be deemed not independent in regard to a particular person if a former officer or employee of such person is employed by the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person. For the purposes of the rule the term "member" means all partners in the firm and all professional employees participating in the audit or located in an office of the firm participating in a significant portion of the audit.
>
> (c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationship existing in connection with the filing of reports with the Commission.[10]

Over the years, beginning in 1937, the Securities and Exchange Commission has published advisories known as Accounting Series Releases. These statements deal with a variety of subjects which relate to the accounting regulations of the SEC. Several of these releases have dealt specifically with independence. They are as follows:

1. ASR 2. Independence of Accountants: Relationship to Registrant. Released May 6, 1937. This release stated the position of the Commission that "an accountant could not be

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[10] SEC Accounting Rules, Topical Law Reports (New York: Commerce Clearing House, Inc., 1968), pp. 125-126.

deemed independent if he is, or has been during the period under review, an officer or director of the registrant or if he holds an interest in the registrant that is significant with respect to its total capital or his own personal fortune."[11]

2. ASR 22. Independence of Accountants: Indemnification by Registrant. Released March 14, 1941. This release stated that if the accountant and the registrant enter into an agreement to indemnify the accountant against all losses arising out of the certification of the statements, other than as a result of the accountant's willful misstatement or omission, then the accountant cannot be recognized as independent.[12]

3. ASR 37. Amendment of Rule 2.01 of Regulation S-X: Qualifications of Accountants Certifying to Financial Statements Required to be Filed with the Commission. Released November 7, 1942. This release talked about disclosure of transactions. It stated the following: "Perhaps the most critical test of the actuality of an

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[11] Ibid., p. 3023.

[12] Ibid., p. 3049.

accountant's independence is the strength of his insistence upon full disclosure of transactions between the company and members of its management as individuals; accession to the wishes of the management in such cases must inevitably raise a serious question as to whether the accountant is in fact independent."[13]

4. ASR 44. Amendments to Rule 2.01 of Regulation S-X Regarding Qualifications of Accountants Certifying to Financial Statements Required to be Filed with the Commssion. Released May 24, 1943. This release stated that the Commission is interested in relationships between a registrant and a certifying accountant only to the extent that a particular relationship might be relevant in determining whether the accountant is in fact independent.[14]

5. ASR 47. Independence of Certifying Accountants: Summary of Past Releases of the Commission and a Compilation of Hitherto Unpublished Cases or Inquiries Arising Under Several of the Acts Administered by the Commission. Released January 25, 1944. This release outlined twenty

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[13] _Ibid._, p. 3076.

[14] _Ibid._, p. 3082.

representative examples of cases where an accountant was considered by the Commission not to be independent in regard to a particular company. The examples discussed cover situations in which there were financial investments and transactions between the company and the accountant, where the accountant served as an officer of the company, where the accountant was related to the management of the company, and where the accountant drew up the monthly records of the company.[15]

6. ASR 81. Independence of Certifying Accountants: Compilation of Representative Administrative Rulings in Cases Involving the Independence of Accountants. Released December 11, 1958. This release enumerates twenty-six situations in which an accountant was held not to be independent. It also discusses twenty cases where an accountant was still considered independent. The release also deals with ten examples of situations where inquiries might be made into the matter of an accountant's independence.[16]

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[15] *Ibid.*, pp. 3085-3089.

[16] *Ibid.*, pp. 3236-3244.

7. ASR 126. Independence of Accountants: Guidelines and Examples of Situations Involving the Independence of Accountants. Released July 5, 1972. This release further sets forth the present guidelines by which the Commission determines questions concerning independence. The Commission states that "the concept of independence is more easily defined than applied."[17] The guidelines are therefore designed to acquaint accountants with typical situations where there has been a loss of independence in appearance or in fact. This serves to point out to the accountant areas of potential danger to his independence.

In general, the reasoning behind any rule on independence is that the client, not the accountant, is responsible for managerial and decision-making functions. If the accountant becomes involved in these functions, then a relationship might develop, or appear to develop, which would prejudice an accountant's professional judgment. On the other hand, an accountant's job is to advise management and give advice on problems. At what point does

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[17] *Ibid.*, p. 3363.

advising end and managerial responsibility begin? The SEC resolves this dilemma by setting forth this guidelines as follows:

> In this context, managerial responsibility begins when the accountant becomes, or appears to become, so identified with the client's management as to be indistinguished from it. In making a determination of whether this degree of identification has been reached, the basic consideration is whether, to a third party, the client appears to be totally dependent upon the accountant's skill and judgment in its financial operations or to be reliant only to the extent of the customary type of consultation or advice.[18]

In line with this policy, the Commission sets out in this release several areas where it feels that the accountant's independence will be questioned. They are as follows:

a) EDP and Booking Services. The SEC feels that an accountant cannot objectively perform an audit on books and records which he has kept for the client because the situation becomes one of the accountant evaluating and attesting to his own record keeping.

b) Financial Interest. There can be no financial interest involved between a client and

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[18] *Ibid.*, p. 3364.

an accountant, his wife or someone under the accountant's supervision. Even if the financial is considered indirect, a test is made to determine if such interest is material by relating the amount involved to the net worth of the accountant, his firm, and the net worth of the client.

c) Family Relationships. The Commission looks here at the strength of the family bond that exists between an accountant and the client. A family relationship may cause outside parties to question any examination made by the accountant.

d) Business Relationships with Clients. Any business relationship other than as a consumer will give the accountant a problem of the loss of appearance of objectivity and impartiality in the performance of the audit. Such relationships appear to cause a conflict of interests.

e) Occupations with Conflicting Interests. The accountant, as an auditor, must appear to be completely objective. If he engages in other activities and relationships as an attorney, as a broker-dealer, or as a direct competitor in a commercial enterprise with

> his client, then the accountant jeopardizes his objectivity and independence as an auditor.[19]

The Securities and Exchange Commission places a great deal of emphasis on an accountant's independence. Although it is hard to define independence because it is an intangible, it is necessary to approach the concept through a practical course. The SEC does this by observing an accountant's behavior and inferring that his behavior is an indication of his thoughts about independence. Therefore, the SEC, in reviewing cases where an accountant's independence has been questioned, looks at all relevant circumstances--an accountant's relationships which would influence his actions as well as the actions themselves. The SEC has the difficult task of enforcing rules and regulations which seek to set guides for an intangible concept--independence.[20]

An Operational Concept of Independence

The concept of independence is a difficult one to grasp, because independence is intangible. It cannot readily be seen by everyone. Consequently, there has been much discussion about independence. Accountants must be

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[19] Ibid., pp. 3365-3372.

[20] Schlosser, "An Historical Approach to the Concept of Independence," p. 521.

concerned with independence because it is a quality which is so essential to the accounting profession. How, then, can persons concerned with the independence of accountants reach a common understanding of the term?

One approach to determining what independence is is to look at independence in terms of an operational concept. Dr. Hussein A. Sharaf and Dr. R. K. Mautz have developed an operational concept of independence in order to help the auditor to evaluate his independence. This operational concept focuses on the operational relationship between the auditor and the client. One phase of such a relationship is that the client's influence or control may be so subtle that the auditor may not be aware of its unless he is constantly alert to such a possibility. In addition, in the auditor's desire to serve the client, the client may influence the auditor more than he should. These possibilities increase the need for a clear concept of independence.[21]

Independence in a client-auditor relationship can be affected by economic pressure, social obligation or personal relationships. The concept of independence is complex and should be subdivided into at least three parts in order to understand more fully the ways in which independence

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[21] Hussein A. Sharaf and R. K. Mautz, "An Operational Concept of Independence," The Journal of Accountancy, Vol. 109 (April, 1960), pp. 51-52.

can be destroyed. The three dimensions of independence are programming independence, investigative independence, and reporting independence. These dimensions are defined in the following manner:

1. Programming independence: Freedom from control or undue influence in the selection of audit technique and procedures and in the extent of their application. This requires that the auditor have freedom to develop his own program, both as to steps to be included and the amount of work to be performed, within the overall bounds of the engagement.

2. Investigative independence: Freedom from control and undue influence in the selection of areas, activities, personal relationships and managerial policies to be examined. This requires that no legitimate source of information be closed to the auditor.

3. Reporting independence: Freedom from control or undue influence in the statement of facts revealed by the examination or in the expression of recommendations or opinions as a result of the examination. The relationship of reporting to the examination has been neatly expressed in the following: "You tell us what to do and we'll tell you what we can write in our report; you tell us what you want us to say in our report, and we'll tell you what we have to do."[22]

Having segmented the concept of independence into three parts, there are guidelines which can be utilized by the auditor to guard against both the obvious and subtle influence on his independence. These guidelines as proposed under the approach of an operational concept of independence are as follows:

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[22] *Ibid.*

Programming Independence

1. Freedom from managerial interference or friction intended to eliminate, specify, or modify any portion of the audit.
2. Freedom from interference with or an uncooperative attitude respecting the application of selected procedures.
3. Freedom from any outside attempts to subject the audit work to review other than that provided for in the audit process.

Investigative Independence

1. Direct and free access to all company books, records, officers and employees and other sources of information with respect to business activities, obligations, and resources.
2. Active cooperation from managerial personnel during the course of the auditor's examination.
3. Freedom from any managerial attempt to assign or specify the activities to be examined or to establish the acceptability of evidential matter.
4. Freedom from personal interests or relationships leading to exclusion from or limitation of the examination of any activity, record or person that otherwise would have been included in the audit.

Reporting Independence

1. Freedom from any feeling of loyalty or obligation to modify the impact of reported facts on any party.
2. Avoidance of the practice of excluding significant matters from the formal report in favor of their inclusion in an informal report of any kind.
3. Avoidance of intentional or unintentional use of ambiguous language in the statement of facts, opinions, and recommendations and in their interpretation.
4. Freedom from any attempt to overrule the auditor's judgment as to appropriate content of the audit report, either factual matter or his opinion.[23]

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[23] *Ibid.*, p. 53.

In order to make full use of the above detailed guidelines, it is necessary for the auditor to examine his activities and working situations in a very direct, unbiased and straightforward manner. If the auditor is able to do this, he can better determine his degree of independence and take corrective action, if need be, to insure that his independence is maintained.

A Behavioral Model of Independence

When an auditor becomes engaged by a client, he is attempting to make an examination of the company's activities in order to form an opinion and render this opinion in a written report. This report is of interest to management, shareholders of the firm and third parties, that is, potential investors, creditors and suppliers. The relationship between the auditor and these three groups can cause pressures which may affect an auditor's independence.

In order to understand the problems associated with an auditor's independence, it is helpful to look at the power that the firm and the auditor possess. The firm's source of power comes from the fact that the firm can choose an auditor from a large group of other auditors, can decide the conditions of employment, and can terminate such employment if desired. In addition, the management supplies the auditor with the facilities and information to do the

job. If management wishes to change the auditor's report, he can terminate the auditor's employment.[24]

The auditor's source of power comes from the type of services he renders to the client and how these services are viewed by the client. The higher the number of nonroutine problems handled by the auditor, the more power he exercises as opposed to the power of the client. In addition, the greater the number of services that the auditor performs directly for the paying client, the more important these services become and consequently, the more power the auditor has. In viewing the auditor as compared to other professionals, for instance lawyers or physicians, it becomes clear that the power weilded by an auditor is low. The reason for this is that most of the problems handled by an auditor are routine and the services provided are paid for by the client but used mostly by third parties. These factors cause the auditor's power to be minimal and put the auditor in a vulnerable position with regard to client pressures.[25]

The auditor's conduct is guided by a code of ethics and standards. When the code of ethics is enforced, an auditor's power is increased. The auditor, however, must

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[24]Arieh Goldman and Benzion Barley, "The Auditor-Firm Conflict of Interests: Its Implications for Independence," The Accounting Review, Vol. 49 (October, 1974), p. 707.

[25]Ibid., pp. 710-711.

constantly be alert to pressures and strive to maintain his independence. The ability of the auditor to withstand pressures is dependent upon the balance of power between the auditor and the firm. This is illustrated in the diagram of a behavioral model of independence shown on the following page. The way an auditor behaves in a professional relationship is a result of many pressures. This behavior will affect the auditor's professional standing and will reflect on his independence.

Aspects of Independence

Independence--A State of Mind

Independence is necessary in the practice of all professions and more especially, accounting. It is most important to understand that independence at its core is a state of mind. If a professional accountant is not convinced in his own mind of his independence, then there is need for some soulsearching. Independence cannot be defined accurately because it is a condition of the mind and character. Independence is a matter of professional integrity, where integrity refers to the sense of uprightness of character, probity and honesty.[27]

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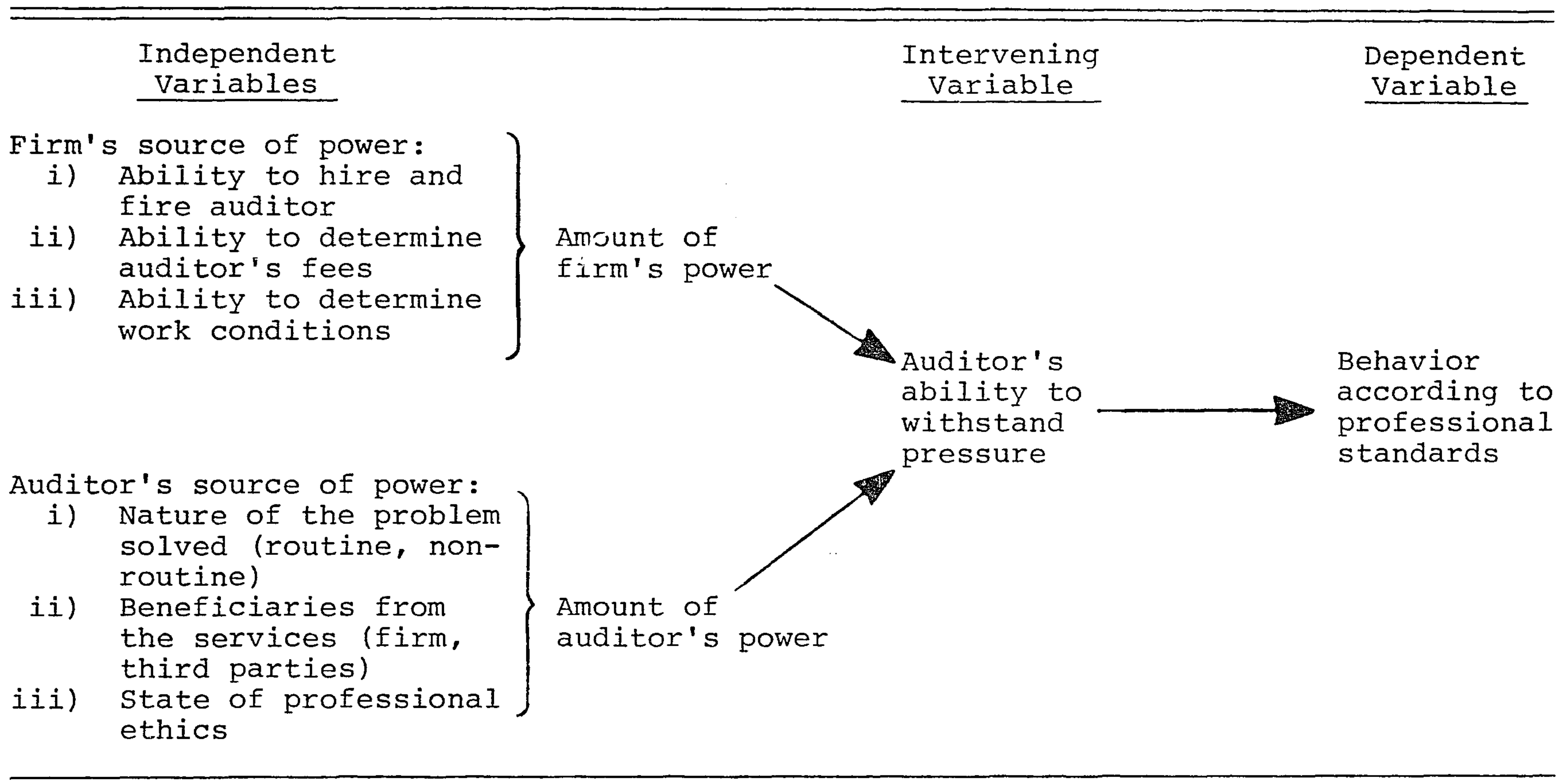
[27] J. L. Carey and W. O. Doherty, "The Concept of Independence: Review and Restatement," The Journal of Accountancy, Vol. 121 (January, 1966), p. 39.

Diagram 1. A Behavioral Model of Independence



Source: Arieh Goldman and Benzion Barlev, "The Auditor-Firm Conflict of Interests: Its Implications for Independence," The Accounting Review, Vol. 49 (October, 1974), p. 712.

While independence is essentially a state of mind, this concept can be explored in terms of three phases of independence as follows: professional independence, audit independence, and perceived independence.

Professional independence refers to that which the auditor must achieve. He must have a nonsubordinate, confident approach and attitude towards his client. The auditor must be free from management's control and influence in making decisions. He must use as a basis for decisions his own professional expertise.[28]

Audit independence is the second phase of independence. This type of independence can be summarized as follows:

> It is most important that the CPA not only shall refuse to subordinate his judgment to that of others but that he be independent of any self-interest which might warp his judgment even subconsciously in reporting whether or not the financial position and net income are fairly presented. Independence in this context means objectivity or lack of bias in forming delicate judgments.[29]

This lack of bias may be viewed on two levels. One level can be called the "objective audit independence." Objective audit independence refers to the auditor avoiding any

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[28] D. R. Carmichael and R. J. Swieringa, "Compatibility of Auditing Independence and Management Services--An Identification of Issues," The Accounting Review, Vol. 43 (October, 1968), p. 698.

[29] John L. Carey, Professional Ethics of Certified Public Accountants (New York: American Institute of Accountants, 1956), p. 21.

intentional favoring of a client's interests in planning the examination, gathering evidence, or preparing the audit report. If an auditor would consciously use ambiguous wording in his report or put important matters in an informal report rather than the formal report, then he would lack objective audit independence. The second level of a lack of bias in audit independence is known as "subjective audit independence." Subjective audit independence refers to an auditor avoiding unintentional feelings which favor a client's interests when the auditor performs his work. For example, an auditor who is basically honest can lack subjective audit independence due to a limited ability for examination. However, an auditor who does not have objective audit independence does not have basic integrity.[30]

Perceived independence is the third phase of independence. It refers to how an accountant's independence appears to the public. There are two facets of perceived independence which need to be examined. On one hand, it is important for a reasonable, knowledgeable person to perceive an individual practitioner as independent. The emphasis is on a one to one basis. Another level of perceived independence is the general public's perception of the whole accounting profession. This level of perceived

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[30]Carmichael and Swieringa, op. cit., p. 698.

independence has to do with a professional image. Individual accountants as well as the profession as a whole should be perceived as being independent.[31]

It is by looking at independence in appearance and independence in reality that the importance of maintaining independence in the accounting profession strongly comes forth.

Independence--Appearance and Reality

An accountant may feel that he is independent when he examines his own state of mind. He may feel that he has a high degree of professional integrity and will do all he can to carry out his assignment honestly and objectively. However, the accountant must also be concerned with the appearance of independence.

A former chairman of the American Institute of Certified Public Accountants' Committee on Professional Ethics pinpointed this problem as follows:

> There are actually two kinds of independence which a CPA must have--independence in fact and independence in appearance. The former refers to a CPA's objectivity, to the quality of not being influenced by regard to personal advantage. The latter means his freedom from potential conflicts of interest which might tend to shake public confidence in his independence in fact.[32]

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[31] Ibid., p. 699.

[32] Thomas G. Higgins, "Professional Ethics: A Time for Reappraisal," The Journal of Accountancy, Vol. 113 (March, 1962), p. 31.

An accountant must know that he is independent. He must also consider how he seems to others. It is impossible for anyone to know exactly how something seems to any person or group. Consequently, the rule of reason must be used.[33]

The following questions could serve as a guideline for determining whether an auditor's independence has been encrouched upon in any way:

1. Will a specific relationship really tempt an auditor to subordinate his professional judgment, despite all sanctions to the contrary?
2. Would it seem to reasonable observers to be likely to do so?
3. How would it affect the public interest? Who is likely to be hurt.[34]

The auditor, in dealing with the problems of independence in reality and independence in appearance, must remember that auditors have to be concerned with how third parties do in fact view the profession--not how the auditors think third parties ought to view the profession.[35]

Having reviewed the American Institute of Certified Public Accountants' ethical standard of independence, the Securities and Exchange Commission's viewpoint on independence and several other approaches and issues involved in

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[33] Carey and Doherty, "The Concept of Independence: Review and Restatement," p. 39.

[34] Ibid., p. 42.

[35] Eugene G. Taper, "Independence--Our Public Image," The Journal of Accountancy, Vol. 126 (August, 1968), p. 67.

understanding the issue of independence, it is useful to summarize the accounting profession's view of independence. In general, the following five statements apply to accountants:

1. We have to _be_ independent.
2. We have to _appear to be_ independent.
3. Independence can't be precisely defined because it is a state of mind.
4. We can't be independent if we have a financial interest.
5. We can't be independent if we are associated too closely with management.[36]

It is this last statement which gives rise to the following question: How can CPA firms who have maintained client relations with one client over a period of years still consider themselves to be independent? Is it not possible that client pressures and influences have built up, perhaps subtly, over the years so as to negate a CPA's independence in fact as well as independence in appearance?

Since independence is so important to the accounting profession, it would appear to be useful to consider any way in which this cornerstone of professionalism could be maintained and strengthened. A possible answer to the problem of maintaining and strengthening independence within the profession is the rotation of auditors. By rotation of auditors, it is meant a compulsory rotation of accounting firms among clients every three to five years. By having

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[36] _Ibid._, p. 65.

CPA firms rotate from one client to another every few years, long associations with their potential buildup of pressures and influences are avoided. The auditor's state of mind is truly independent because he knows that his work will be reviewed by other accountants from other firms that will follow. The auditor's sense of professional integrity is heightened because he knows there is nothing to gain by letting his work be influenced by management pressures. In addition, a CPA's independence in fact and in appearance is strengthened. This is something with which the auditor must continually be concerned.

The rotation of auditors is a possible answer to the problem of maintaining independence within the accounting profession. Likewise, the maintaining of independence is set forth as the chief advantage of adopting a policy of rotation of auditors.

A Fresh Point of View

A second advantage often cited by those who advocate a policy of rotation of auditors is that such a policy offers the client a fresh point of view. A firm which has a long, close association with a client may tend to approach the work for the client in a casual manner. A certain laxness in the auditor's approach might result after a period of years.[37]

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[37] Robert K. Mautz, "Rotation of Auditors," *Financial Executive*, Vol. 42 (July, 1974), p. 53.

Rotation of auditors can bring in new auditors who have a fresh point of view and possibly a different approach to the existing accounting operation. With this fresh point of view, a new auditor may discover problems which the previous auditor failed to notice. The new accounting firm which is hired to replace an old firm brings with it new blood. This causes everyone connected with the audit to be more alert.[38] The present firm of auditors will generally perform an audit of higher quality because they know that another firm will be reviewing their work at a later date.[39]

Rotation of auditors is practiced by some of the large CPA firms in assigning auditing staffs to clients. Every year or two the members of an auditing team are rotated so that the same people do not audit the same client year after year. The same firm audits the client, but not the same people.

Although this type of rotation is better than no rotation at all, it does not go far enough. Even though the audit team members are rotated, the work is still overseen and reviewed by the same audit manager. Therefore his viewpoint and approach to the client's problems are the

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[38]N. Loyall McLaren, "Rotation of Auditors," The Journal of Accountancy, Vol. 106 (July, 1958), p. 42.

[39]Alan J. Winters, "Looking at the Auditor Rotation Issue," Management Accounting, Vol. 57 (March, 1976), p. 30.

same year after year. Another problem is that a staff auditor may have a certain expertise in a given area and cannot be rotated away from a particular client because there is no one else qualified to replace him. This means that the same person audits the same client year after year.

It is difficult to be completely objective when reviewing your own work. An audit staff which comes in to review work done in the past by the same firm already has a bias that the work is correct and presented in the best manner possible simply because their firm did the work. The overall philosophy and viewpoint of the auditing firm is still exercised year after year even though the rotation of auditing staff members is practiced.

The rendering of an audit opinion by a newly engaged firm of certified public accountants offers a new, fresh, and completely objective analysis of a client's financial position and his accounting procedures. A policy of rotation of auditors is a means of securing such opinions. Rotation of auditors supplies the client with another professional opinion and a fresh insight into his business operations. Previously undetected problem areas may come to light, as well as new methods or systems for handling the operations of the client's business.

Reducing Litigation Against Accountants

A third advantage of a policy of rotation of auditors is the possible reduction of litigation against accountants. In today's environment where numerous cases against accountants are being tried in the courts, this is an important advantage to examine and consider.

In the past ten years, the cases involving accountants have grown in number. Persons who suffer financial losses in dealing with companies are turning more and more to accountants as a possible source from which to obtain some reparation. The accounting profession as a whole seems to have developed into a perfect object against which to bring any malpractice claim based on allegedly faulty audits which arise supposedly as a result of oversights, improper accounting practices or accounting methods which were negligently carried out.[40]

How Does Litigation Affect the Accounting Profession?

In answering this question, it is helpful to review some of the more prominent cases involving accountants. By doing so, the results of these cases will shed some light on the effect of litigation on the accounting profession. In addition, in order to understand the legal basis for

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[40]Arnold Levine and E. Stanley Marks, "Accountants' Liability Insurance--Perils and Pitfalls," The Journal of Accountancy, Vol. 142 (October, 1976), p. 59.

some of the cases brought against accountants, it is necessary to examine the fundamental security acts set forth by the Securities and Exchange Commission in the 1930's.

Ultramares Corporation v. Touche (January 1931)

The Ultramares Corporation v. Touche case involved an action brought by a company, who dealt with Fred Stern and Company, against the public accounting firm of Touche, Niven and Company. Fred Stern and Company was in the business of importing and selling rubber. The plaintiff company did business with Fred Stern and Company chiefly as a factor. Touche, Niven and Company audited the statements of Fred Stern and Company and expressed a clean opinion on them. The plaintiff company relied on the statements in making substantial loans to Fred Stern and Company. Nearly a year later, Fred Stern and Company declared bankruptcy. The plaintiff company action was brought against Touche, Niven and Company to recover the losses which it sustained from the loans, which were made based on a misrepresentation of the accountants. The action was for negligence and fraud.[41]

The court concluded that there was no proof of fraud and therefore no liability against the accountants. As to

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[41]Ultramares Corporation v. Touche, 255 N.Y. 170 (November 18, 1930 to February 19, 1931), pp. 175-176.

the question of negligence, Judge Cardozo had this to say:

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.[42]

The court felt that it would be against public policy to subject accountants to a completely open-ended liability which would be based on the certification of the financial statements. If, however, an accountant's work was proved to be fraudulent or grossly negligent, he would be held liable to a larger group of persons, rather than just to the client or a person who was known to be a key user of the information.[43]

A plaintiff, as a result of this case, had the burden of establishing certain elements in any action brought against accountants. He would have to prove that he was adversely affected by relying on the financial statements and gather enough evidence to prove that the accountant was grossly negligent when he conducted his audit. Finally, a

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[42] Ibid., pp. 179-180.

[43] Henry B. Reiling and Russell A. Taussig, "Recent Liability Cases--Implications for Accountants," The Journal of Accountancy, Vol. 130 (September, 1970), p. 40.

plaintiff would have to prove that he was a member of the group of possible foreseen plaintiffs that might bring an action against the accountant.[44]

Securities Act of 1933 and the Securities Exchange Act of 1934

After the Ultramares case, in March of 1932, the United States Senate authorized an investigation into the practices of stock issuers and brokers. As a result of the report to the House of Representatives, Congress wanted regulation of securities. The legislation which was produced was the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities and Exchange Commission was formed under the authority of the Securities Exchange Act of 1934 to carry out the laws under the two acts.

The objective of the Securities and Exchange Commission and the acts was to make certain that investors were provided with complete disclosure of important facts regarding publicly offered securities. The Securities Act of 1933 had the primary purpose of regulating the initial offering and selling of any securities that utilize the mail to make offers or to distribute stock. This regulation is accomplished mainly through the requirement that

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[44]Michael Kennedy, "Accountants' Liability Overview," Pennsylvania C.P.A. Spokesman, Vol. 46 (November, 1975), p. 5.

any company offering securities must file a registration statement and a prospectus containing financial information most of which has been certified by an independent accountant.[45]

Section 11 of the Securities Act of 1933 provides any person, who has bought a security for which a registration statement has been filed, with a federal right of action if the registration statement contains misleading statements or information or if it fails to include information which would make the registration statement misleading. This section of the Act caused two changes to occur as regards the civil cases brought against accountants. First, this section significantly enlarged the group of potential plaintiffs who could sue accountants than had previously been the case. Second, the burden of proof rested less with the plaintiff and more with the accountant. Basically, if a plaintiff could prove that the information in the registration statement was misleading, then the company involved had no possible defense. Consequently, the accountant was open to liability to third parties unless he could substantiate a defense of "due diligence."[46] "Due diligence" is defined in Section 11(b) of the Securities Act of 1933 as follows:

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[45] K. Fred Skousen, An Introduction to the S.E.C. (Cincinnati: South-Western Publishing Company, 1976), p. 19.

[46] Kennedy, *op. cit.*, p. 6.

> . . . no person, other than the issuer, shall be liable . . . who shall sustain the burden of proof . . . (3) that (A) as regards any part of the registration statement not purporting to be made on the authority of any expert . . . he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein not misleading; . . . and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) . . . he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . .[47]

The Securities Exchange Act of 1934 basically extended the regulation of securities beyond the initial offering and distribution. This Act embodies all of the necessary authority to regulate the buying and selling of securities on national exchanges. With the extension of the laws to cover not only the initial offering of securities, but also the continuous buying and selling of securities, the accountant was further plagued with the possibility of federal actions brought in connection with continuous buying and selling transactions.[48]

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[47] Securities Act of 1933, Statutes at Large, Vol. 48, Ch. 38, p. 82.

[48] Kennedy, op. cit., p. 6.

McKesson and Robbins, Inc. (December 1938)

Under the Securities Exchange Act of 1934, an action was brought against McKesson and Robbins, Inc., based on the supposition that the information in the registration statement and financial statements was false and misleading. The statements were prepared and certified by Price, Waterhouse and Company. The fraud resulted in a figure of more than $87,000,000 in consolidated assets being reported on the financial statements, of which approximately $19,000,000 were entirely fictitious. In reviewing the case, the Court addressed itself to several points, including the specific auditing procedures employed, the degree to which generally accepted standards were followed, and the sufficiency of safeguards in the standards to guarantee reliable and accurate financial statements.[49]

The court concluded that the statements conformed with generally accepted procedures but that there should be a considerable advancement made in developing auditing procedures to verify records and documents by actual physical inspection of items involved.[50] As a result of the case, the accounting profession established new standards with regard to confirming accounts receivable and observing inventories.

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[49] SEC Accounting Rules, Topical Law Reports (New York: Commerce Clearing House, Inc.), pp. 3039-3040.

[50] Ibid., p. 3045.

Yale Express (April 5, 1967)

In the Fischer v. Kletz case, better known as the Yale Express case, the plaintiff brought action against the accounting firm of Peat, Marwick, Mitchell and Company in connection with the financial statements of Yale Express System, Inc., a company involved in national transportation. The action was brought against the accountants as a result of their failure to disclose figures which were discovered to be materially false and inaccurate.[51]

The original financial statements for the year 1963 were audited and certified on March 31, 1964. In April the statements were issued to the stockholders. In June, the statements were included in a Form 10-K Report which was filed with the Securities and Exchange Commission. However, early in 1964, Peat, Marwick, Mitchell and Company was hired to perform special studies of past revenue and expense items. As a result of the study, Peat, Marwick, Mitchell and Company found the figures in the 1963 annual report to be false and misleading. It was not until May of 1965 that the auditors disclosed these results to the stock exchanges, the Securities and Exchange Commission or the public.[52]

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[51] Fischer v. Kletz, 266 F.S. 180, pp. 182-183.

[52] *Ibid*.

In addition to the above stated facts, although Yale wanted to issue interim statements, Peat, Marwick, Mitchell and Company said that the company could not use the results of the special studies in the interim statements. The figures which were used in the interim reports were those generated through Yale's own internal accounting procedures. The resulting interim statements contained unaudited and uncertified figures, which were shown to be false and misleading. The charge against Peat, Marwick, Mitchell and Company by the plaintiffs was that they should have disclosed the fact that the 1963 financial statement figures as well as the interim statement figures were false and misleading at the time such information was discovered. The plaintiffs' contention was that the accountants had a duty to disclose this information since they knew that the public would rely on the audited and certified statements. Peat, Marwick, Mitchell and Company contended that there was no common law or statutory basis for performing such a duty as accountants hired by Yale Express System, Inc. According to the auditors, the duty to report to the public ended when they certified the 1963 financial statements.[53]

Judge Tyler issued an opinion on this case. With regard to the work of Peat, Marwick, Mitchell and Company

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[53]Ibid.

as auditor of the financial statements, the firm was an independent public accountant. As such, his responsibility, as stated by Judge Tyler, "is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies. . . . The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client."[54] After certifying the financial statements, Peat, Marwick, Mitchell and Company assumed a new role of an accountant hired to do special studies whose first duty was to his client rather than to the public. As a result of these two different roles and the discovery of materially false and misleading information, a problem arose. As Judge Tyler stated.

> The serious question arises as to whether or not an obligation correlative to but conceptually different from the duty to audit and to certify with reasonable care and professional competence arose as a result of the circumstance that Peat, Marwick, Mitchell and Company knew that investors were relying upon its certification of the financial statements in Yale's annual report.[55]

A resolution to this question was not a point discussed in Judge Tyler's opinion. However, the Yale Express case, in posing this unique question, lead the accounting

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[54] Ibid., p. 184.

[55] Ibid.

profession to issue in October of 1969 Statement on Auditing Procedure 41 entitled "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report." This statement says, in essence, that when subsequent facts are discovered and determined to be reliable, revised financial statements should be issued. In addition, disclosure should be made to the Securities and Exchange Commission, stock exchanges and any other persons known to be relying on the financial statements.[56]

Escott v. BarChris Construction Corporation (March 29, 1968)

In the BarChris case, the purchasers of convertible debentures brought action against BarChris Construction Corporation, the corporation underwriters and the auditors under Section 11 of the Securities Act of 1933. The charge was that the registration statement contained statements which were considered materially false and that the statement exhibited material omissions.[57]

At issue in the case was one point involving a sale and leaseback transaction. The courts ruled that the profits on such a transaction should have been eliminated.

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[56] Statement on Auditing Procedure 41: Subsequent Discovery of Facts Existing at the Date of the Auditor's Report (New York: American Institute of Certified Public Accountants, Inc., 1969), pp. 69-70.

[57] Escott v. BarChris Construction Corporation, 283 F.S. 643 (S.D.N.Y. 1968), p. 643.

As of the date of the statements, there was no clear-cut rule within the accounting profession on the treatment of sale-leaseback agreements. However, as a result of the court being presented with several accounting methods in the BarChris case, the court outlined a treatment it considered proper.[58] This expostulation of preferred accounting methods by the courts can have far reaching effects on the profession.

The BarChris case itself was the first important case decided under Section 11 involving a major firm. The defendants in the BarChris case used the "due diligence" defense as stated in Section 11(b) of the Securities Act of 1933. The courts ruled that the new directors were liable for statements if they did not investigate statements by posing questions of experts, which they did not. As a result of this finding, directors are asking their auditors to examine and give an expert opinion on more of the information submitted to the Securities and Exchange Commission than was previously done. The accountants attempted to use the "due diligence" defense in the case by stating that when the registration statement went into effect, they believed that the audited statements were not misleading. To arrive at this conclusion the accountants had to examine the company's S-1 Form for registration

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[58] Reiling and Taussig, op. cit., pp. 41-42.

under the Securities Act of 1933. The failure of the auditors lay in not properly carrying out all the steps in the S-1 program as it was written. The court ruled that the accountants had therefore failed to show "due diligence." This ruling illustrates new areas of concern for the accounting profession. Where there were undefined standards of practice, the courts may very well stipulate standards.[59]

Continental Vending (June, 1968)

In United States v. Simon, criminal action was brought against the accounting firm of Lybrand, Ross Bros. and Montgomery, specifically against two partners and an audit manager. The United States Attorney's office for the Southern District of New York instituted the case.

The case involved the certification of misleading financial statements by Lybrand, Ross Bros. and Montgomery. The misleading financial statements involved the reporting of sizable loans by Continental Vending to an affiliate, Valley Commercial Corporation. The loans in fact were loans to the president of Continental for his personal stock market transactions. The collateral pledged by the president for the loans through Valley Commercial Corporation

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[59] Ibid., pp. 43-44.

was inadequate. However, the footnote on the Continental financial statements, to which the auditors attested, did not disclose this information. The court said that the prosecution had only to prove that the accountants had certified a financial statement which they knew to be false. The result of the case was that the accountants were found guilty by a jury.[60]

The importance of this case for the accounting profession is that it was a criminal action rather than a civil action involving a major accounting firm. Such cases, prior to this time, had been infrequent. As a result of this case, it is necessary for public accountants to realize that they are not free from legal liability simply because they adhere to generally accepted auditing standards and generally accepted auditing principles. Such principles and standards are looked upon only as minimum requirements for the public accountant.[61]

Ernst and Ernst v. Hochfelder
(March 30, 1976)

The case of Ernst and Ernst v. Hochfelder involved a charge of negligence in failing to uncover fraudulent practices in the First Securities Company of Chicago, a

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[60]Reiling and Taussig, "Recent Liability Cases--Implications for Accountants," pp. 48-49.

[61]Charles Gibson, "Analysis of Continental Vending Machine (U. S. v. Simon)," Ohio C.P.A., Vol. 30 (Winter, 1971), p. 16.

brokerage firm and member of the Midwest Stock Exchange. Leston B. Nay, president of First Securities Company, convinced the plaintiffs, who were customers of First Securities, to invest in escrow accounts which would give a high rate of return. Mr. Nay used the funds for his own purposes. In 1968, when Nay committed suicide, he left a note explaining that there were really no escrow accounts and that First Securities Company was bankrupt, since he owned 92% of its stock. All of the transactions for the funds into the escrow accounts were unrecorded and the customers never received any receipts for their deposits or an accounting of the balance in the escrow accounts.[62]

Ernst and Ernst had done the audit work for First Securities Company from 1946 to 1967. They had also prepared the annual report which was filed with the Securities and Exchange Commission. The customers brought charges against Ernst and Ernst under Section 10(b) of the Securities Exchange Act of 1934 and the SEC Rule 10b-5. The charge was that Ernst and Ernst was negligent in its application of auditing procedures since it failed to discover the fraud. The fraud was mainly executed by means of Leston Nay's mail rule. All mail addressed to Nay was to be opened only by him even if he was absent from his desk for long periods of time. The plaintiffs charged that

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[62]Ernst and Ernst v. Hochfelder, 425 U.S. 185, 47 L.Ed.2d 668, p. 189.

effective auditing would have investigated this mail rule and disclosed the fraud. The case brought by the customers clearly stated that they were not charging Ernst and Ernst with intentional fraud, but only with "inexcusable negligence."[63]

Ernst and Ernst v. Hochfelder directly confronts the courts with the question of what is the scope of an accountant's liability under Rule 10b-5. Previous to this case, the scope of an accountant's liability had been more subject to interpretation. Some courts, in previous cases, understood the rule to cover both negligent and intentional conduct. Other courts felt that the rule was directed only at an intentional participation in a fraud.[64]

The opinion in Ernst and Ernst v. Hochfelder was significant because it narrowed an area of the accountant's liability. The way in which the language of Rule 10b-5 under Section 10(b) was interpreted in past cases left accountants wide open to potential investor-plaintiffs. Courts who felt that language such as "manipulative" and "deceptive" in the rule applied not only to an intentional act of fraud, but also to a negligent act, wanted the rule and statute to protect investors from all bad practices--

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[63] Ibid., p. 190.

[64] J. Jay Hampson, "Accountants' Liability--The Significance of Hochfelder," The Journal of Accountancy, Vol. 146 (December, 1976), pp. 69-70.

both intentional and negligent. This set up a negligence standard in Rule 10b-5(2). In the Ernst and Ernst v. Hochfelder case the Supreme Court discarded this broadened interpretation of Rule 10b-5. The court stated the following:

> Viewed in isolation the language of subsection (b), and arguably that of subsection (c), could be read as proscribing, respectively, any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not.[65]

The result of the Hochfelder decision, as far as the accounting profession is concerned, is that it is more difficult to bring suit against accountants. Under Rule 10b-5, an accountant can now be said to be liable only if, to some degree, he had knowledge of the fraud or some participation in it. This decision of the Supreme Court in Ernst and Ernst v. Hochfelder gives hope to the accounting profession. It stops the public from believing that an accountant is involved in fraud when a charge only involves negligence. This decision helps to emphasize what an investor can expect from financial statements as opposed to what is the auditor's duty.[66]

Each of these cases discussed above points out some area where the accountant was found to be less than

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[65]Ernst and Ernst v. Hochfelder, op. cit., p. 212.

[66]Hampson, op. cit., pp. 73-74.

thorough in the performance of his duty as an auditor. Each of the cases resulted in some action being taken, either by the Securities and Exchange Commission or the American Institute of Certified Public Accountants, which involved the profession. The cases discussed are only a sample of the number of cases involving accountants which have been brought before the courts. The number of cases seems to grow year by year. Since there is a trend of bringing legal suits against accountants and putting their liability to a test, a person outside of the accounting profession might wonder at the reason for all of the litigation which has built up over the last fifteen years.

Why Does Litigation Against Accountants Continue?

The increasing amount of litigation that is instituted against accountants has caused many to wonder about the credibility of auditors. In conjunction with increased litigation, there has been a great deal of criticism from the public and the Securities and Exchange Commission in the press and in speeches.

Why does this situation exist? In 1973, a group of professional leaders met with the Board of Directors of the American Institute of Certified Public Accountants to discuss the causes and solution for this situation. After some discussion the consensus of opinion was as

follows: "A gap exists between the expectations of the users of auditor's services and what the profession believed was feasible to provide."[67] This gap could be called the "responsibility gap."

In general, criticism of accountants arises when a business fails or a company experiences significant losses. It is then that charges are leveled against auditors who supposedly have failed to execute their duty in one of two ways. Either the auditor neglected to ensure that the accounting and financial reporting and disclosure were correct or the auditor did not do a proper job of auditing and was therefore guilty of negligence or possibly fraud.[68] In response to all of this litigation against accountants, all types of persons have expressed opinions on the accountant's responsibilities. These persons include investors, credit grantors, spokesmen for stock exchanges, bankers, financial analysts and prominent businessmen, as well as auditors themselves.

The responsibility gap exists between accountants and the public because of the failure of the public to understand the responsibilities of the accountant as they exist in the context of an audit performed to render an

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[67]Wallace E. Olson, "A Look at the Responsibility Gap," The Journal of Accountancy, Vol. 139 (January, 1975), p. 52.

[68]*Ibid*., p. 53.

opinion. Areas of misunderstanding exist with regard to the auditor's following responsibilities:

1. Detection of fraud and irregularities
2. Judgments in appraising the application of generally accepted accounting principles
3. Due care in conducting an opinion audit
4. Judgments where there are no established standards
5. Judgments about reasonableness of the total result of individual parts.[69]

These areas of misunderstanding basically boil down to one problem between what the public believes and what is in fact the case. The responsibility gap, also referred to as the expectation gap, is best summed up in the following manner: "The consuming public, many regulators, courts, and lawyers believe that the auditor is a guarantor or insurer of the company's financial solvency."[70] The reason behind this is that accountants use numbers which imply exactness and so the public views financial statements as being accurate. Even though assets equal liabilities plus ownership equity, the public does not realize that the precision ends at that point. The accounting profession complicates the matter by using words such as "certified" in relation to financial statements. The result of all this is that an expectation gap, a responsibility gap, has

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[69] Ibid., p. 54.

[70] Carl D. Liggio, "The Expectation Gap: The Accountant's Legal Waterloo?" The C.P.A., Vol. 45 (July, 1975), p. 24.

arisen between what the public expects and what an accountant can reasonably be capable of performing.[71]

Until the gap is lessened, the accounting profession can expect to experience more and more lawsuits in addition to more criticism.

What Can Accountants Do to Protect Themselves?

In general, with the abundance of litigation as a reality faced by the accounting profession, the best way for an accountant to protect himself is to render to his client his best performance. If a suit follows, an accountant should be firm in defending himself. The best method of discouraging potential plaintiffs is to defend and refute cases which are not based on any merit.[72]

When the accountant looks to specific guidelines that will help him to protect himself, there come to light several articles which have been written since 1969 about rules for minimizing liability risks.[73] These rules or

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[71] Ibid., p. 25.

[72] Victor M. Earle, III, "The Litigation Explosion," The Journal of Accountancy, Vol. 129 (March, 1970), p. 67.

[73] For a comprehensive discussion of these rules, see: Donald Stuart Bab, "The CPA's Expanding Legal Liability," The Practical Accountant, Vol. 6 (March/April, 1973), pp. 43-50; James P. Bedingfield, "The Effect of Recent Litigation on Audit Practice," The Journal of Accountancy, Vol. 135 (May, 1974), pp. 55-62; Joe R. Fritzemeyer, "Seven Rules for Minimizing the Risks of Liability," The Journal of Accountancy, Vol. 127 (June, 1969), pp. 64-65; Richard L. Miller, Jr., "Cases on Accountants' Liability--Some Rules of Safe Practice," Pennsylvania CPA Spokesman, Vol. 46 (Novem-

guidelines for accountants can be outlined and summarized as follows:

1. Be careful in selecting or accepting new clients. Avoid taking clients whom you consider to be untrustworthy. Even though audit standards do not include guidelines for reviewing a potential client's reputation, it is important for the accountant to use his judgment especially in the case of a client whose standards are not in accordance with those of most businesses and other professionals. This special care is necessary to protect the accountant and also to decrease the possibility of financial losses for persons investing with a potential client.
2. Once the client has been accepted, write up the agreement of the work to be done in an engagement letter. Make the client cognizant of the fact that the certified public accountant is not an insurer and explain to him exactly what duties and responsibilities the accountant takes upon himself.
3. Once the terms of the engagement have been settled, be sure that there are an adequate number of mature and experienced persons staffing and supervising every phase of the work.

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ber, 1975), pp. 7-13; Norman O. Olson, "The Auditor in Legal Difficulty--What's the Answer?" The Journal of Accountancy, Vol. 129 (Spril, 1970), pp. 39-44.

4. Carry out every step listed in the engagement letter thoroughly.
5. Know the client's business and be aware of trouble spots. Take special care in these areas. Later, if the courts say that you as the accountant knew or should have known about a particular problem, you can say that you did know.
6. It is essential to be thoroughly knowledgeable about generally accepted auditing standards and procedures and generally accepted accounting principles. Do not rely on these standards and principles totally. The compliance of the accountant with these guidelines is not always a complete defense before a court of law. The courts consider the body of professional literature as a minimum test to meet against liability. An accountant's professional judgment rather than mere adherence to rules is more significant before the courts.
7. Be thorough in writing up working papers. Be sure that they are complete, reviewed and retained in the client's file.
8. When writing footnotes and reports on audited financial statements, exercise extreme care. Be sure everything in the report is stated clearly, not just to fellow accountants but to laymen as well.

9. In going through the audit program, be sure that every step as listed is carried out. If any change is made, make reference to it in writing and explain the change, the reason for it, and the result of the change in the overall program.
10. If in performing procedures, exceptions turn up in testing, be sure that these exceptions are examined and eliminated in a satisfactory manner. Be sure that the working papers document the exceptions as well as what was done about them.
11. Explain exactly what work you have done and, if appropriate, what work you have omitted. When a phase of the work has been conducted differently from a standard engagement, it becomes critical that the language in your report is clear.
12. Consult legal counsel if you have a question about disclosure problems. Often the problem involved is not so much a matter of accounting as it is a matter of legal disclosure requirements. In this case, a lawyer may be able to supply some helpful advice.
13. Be prompt in billing and collecting fees. If unpaid bills are allowed to exist, a question about the accountant's independence and objectivity may arise in the minds of third parties.
14. Obtain adequate insurance which will cover risks as well as legal expenses of defending a case if the need should ever arise.

15. Maintain regular direct contact with the board of directors of the client. The board of directors should be made aware of any disputes which arise between management and the accountant. These measures help to maintain the independence of the accountant.
16. Be sure of all the accounting rules and procedures, but go one step further. Ask yourself: Does it make sense? Does the result of the work from an overall viewpoint make sense? Is the result likely to mislead a third party, i.e., "an uninformed but reasonable man"?

With all of these rules and guidelines to follow in order to minimize the possibility of litigation, the accounting profession might consider yet another rule or guideline. The guideline that is being proposed here is the systematic rotation of auditors. This policy would help to reduce the possibility of litigation. This would be accomplished in the following manner. A policy of rotation would cause the present auditors engaged by the company to be more exact and thorough in their work since they know that other auditing firms would be succeeding them. The new firms would be reviewing the previous auditor's methods and procedures used in performing the audit engagement. This pressure of a review by another auditing firm would cause the auditors to fully examine and attempt

to solve problem areas in the accounting system, thereby exploring some of the potentially dangerous areas which give rise to much of the costly litigation brought against accountants. In addition, the fresh point of view brought to a job by a new auditing firm would give the client a more objective, critical review which would also help to ferret out problem areas which could lead to litigation.

The majority of cases brought against accountants involve charges of negligence and/or fraud. By rotating the auditors, the present auditors would be more diligent and critical in their work due to professional pressure and would thereby reduce the possibility of litigation brought against accountants on the basis of negligence and/or fraud.

Summary

Over the past several years, the accounting profession has come under more and more scrutiny by the public, the courts, and the Securities and Exchange Commission. The pressure has been put on the profession more and more to render accounting services with a high degree of integrity and independence. One of the ways in which this might be accomplished is to adopt a policy of rotation of auditors. The primary advantage of such a policy is the maintaining and strengthening of independence. Another advantage would be the offering of a fresh point of view to

clients. A third advantage would be the reduction of the ever increasing amount of litigation brought against accountants. This chapter has discussed these three advantages. The following chapter will present the disadvantages of adopting a policy of rotation of auditors within the accounting profession.

Chapter 3

THE DISADVANTAGES OF THE ROTATION OF AUDITORS

In the process of considering a policy such as rotation of auditors, it is necessary to understand and discuss the disadvantages of such a policy. In the preceding chapter the advantages were pointed out. This chapter will concentrate on the disadvantages. What exactly are considered the disadvantages of a policy of rotation of auditors?

The disadvantages of a policy of rotation of auditors are as follows:

1. Loss of large clients by CPA firms,
2. Adverse effects of installing new auditors,
3. Experience and information loss from previous audits, and
4. Disruption of types of services offered to the client.

Before discussing each of these disadvantages, it is necessary to clarify a point concerning a policy of rotation of auditors. If such a policy becomes general, it will be as a result of pressure from clients, and possibly the Securities and Exchange Commission and/or government.

This policy of rotation of auditors will be imposed on the CPA firms; in other words, the policy may become one of mandatory auditor rotation.

Loss of Large Clients by CPA Firms

One of the disadvantages of a policy of rotation of auditors is the loss of large clients by the CPA firms. This point is never specifically mentioned in articles which discuss the topic of rotation of auditors. The loss of clients by the CPA firms is a disadvantage from the point of view of the firm that is losing the client, whether the client is large or small.

A CPA firm that has done good and conscientious work for a large client and that has worked to cultivate a long and successful relationship would view the loss of such a client as a primary disadvantage of such a policy as rotation of auditors. The long years of association and close communication would be viewed as a tremendous asset to the working relationship between a client and a CPA firm. To rotate the CPA firms among clients would make the CPA firms feel that the effort put forth over the years for more efficient communication and better performance of the audit engagement was for naught. No CPA would not be able to build upon the hours of work, in some cases the years of work, which have been invested with a given client.

Putting aside the issue of a good, long working relationship, no CPA would like to lose a large, steady

client as a source of revenue. This point is never mentioned in articles on rotation of auditors. However, it should be. Large clients involve large fees. To build up a steady clientele takes years of work. If the policy of auditor rotation becomes general, a given CPA's clientele would be continuously changing and would cause new assessments to be made in terms of both the time and effort necessary to be expended on each client every year, not to mention the fluctuation of anticipated revenue from fees.

Adverse Effects of Installing New Auditors

The second disadvantage of rotation of auditors can be discussed in terms of the problems which arise when new auditors are installed. If a policy of rotation of auditors was adopted, the adverse effects of installing new auditors would have to be dealt with on a frequent basis. Examination of these adverse effects focuses attention on the following separate areas:

1. Effect on fees
2. Effect on time
3. Effect on efficiency

Effect on Fees

Before discussing the ultimate effect of installing new auditors on the amount of the fee which a CPA firm

charges a client, it is perhaps helpful to understand the components of a fee and how a fee is determined.

Basically a fee must be such as to cover direct expenses and general operating expenses, and also to earn a return for the partners of the firm. Accountants generally take into consideration several of the following factors when determining a fee:

1. Time spent on the engagement
2. Technical importance of the engagement (the responsibility assumed)
3. Value of the services to the client
4. Risk factors involved
5. Staff availability
6. Ability of the client to pay
7. Maintaining professional standards (attendance at conferences, additional schooling, etc.)
8. Maintaining our facilities (staff, office equipment, library costs, etc.)
9. Reputation of the firm (will it be enhanced by performing the services for the client?)
10. Our "life needs" (enough money to provide a desired standard of living)
11. Keeping pace with national economic picture (rate-of-inflation, adjustments)
12. Minimum fee factors (the going rate within the community; what was charged in prior years or in similar circumstances)
13. Various ethical considerations.[1]

The Objective Portion of a Fee

The objective portion of a fee can be looked upon as being composed of a time factor, a research element, and certain direct and overhead expenses.

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[1]Bernard B. Eder, "A Three-Step Method of Arriving at a Fair Fee," The Practical Accountant, Vol. 5 (July/August, 1972), p. 28.

The first of these components, time, is unquestionably the largest element of any fee. In general, this factor is viewed mostly from the standpoint of the number of hours worked by the auditing staff. Their hourly rate would be based upon their salary, payroll taxes, insurance expense and other expenses directly related to the staff. Since the time devoted by the staff to a particular engagement is such an important factor, it is necessary to keep very accurate records of the time spent on each particular assignment.[2]

In addition to the staff time, it is equally important for the time which a partner spends administering, planning and supervising the total effort of the engagement to be added into the fee. Even though the partner's part of the fee may be more arbitrarily determined, this does not mean that it can be overlooked.[3]

Another phase of the time component which must be discussed is the time which is spent by the clerical staff in typing and proof-reading final reports. How should this be handled? Should it be charged to the client or treated as a part of overhead? Either method is acceptable, although most firms will generally include in the fee a

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[2]W. H. Morgan, "The Objective Elements in a Fee," _The Accountants' Journal_ (New Zealand), Vol. 52 (October, 1973), p. 114.

[3]_Ibid._

charge for the amount of time the clerical staff spent on the work of a given client.[4]

The second objective component of a fee can be accounted for in terms of the amount of research that is necessary to complete a particular assignment. In some cases it is necessary for some research to be done to determine the generally accepted accounting principles that apply or the pertinent auditing procedures that must be carried out. Other cases may require investigation to determine whether the client conforms to certain rules and regulations enforced by government agencies. The area where the most research may be done is in the area of a client's tax problems. A considerable amount of research time may need to be devoted to this area.[5]

The third objective component of a fee involves certain direct and overhead expenses. Direct expenses are such items as out-of-town travel, hotel accommodations, meals, and business telephone calls. These are types of expenses which might arise if an auditor is required to go out of town on a client's engagement. Generally, these items are included in the client's fee. Overhead expenses are those expenses of the firm which help the firm to operate a going practice. These items include rent,

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[4] *Ibid*.

[5] *Ibid*.

telephone, insurance, office supplies, office equipment depreciation, and any time of the partners which is non-chargeable to a given client. The total of all these items is applied to the clients on the basis that these expenses are necessary to keep the firm operating and available to render services to all of the clients. The basis for application of overhead costs to each client might employ an hourly burden rate. This hourly burden rate would be derived by dividing the total overhead cost by the total number of hours chargeable to clients for a given year. A better method, however, would be to charge each client with overhead depending upon the level of work done. In other words, work done by the junior staff member as opposed to work done by a partner would carry a lower overhead charge per hour.[6]

In the final analysis, a fee is objectively based on the amount of time spent by the staff and partners on the engagement. The time value of a fee can be expressed as composed of a labor rate, the difficulty of a job and the ability of the staff man.[7] In addition, another part of the fee is the result of an allocated portion of overhead.

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[6] Ibid., p. 115.

[7] Eder, "A Three-Step Method of Arriving at a Fair Fee," p. 28.

The Subjective Portion of a Fee

The subjective portion of a fee is based upon a determination of what is of value to a client. The technical importance of the work done for a client, the importance of the services rendered to the client, the personal judgment factor of the accountant, and the extent of convenience extended to the client are the major factors which cause a fee to have a certain portion which is subjectively determined.

What are the elements of value that are looked for in an engagement? There are three general groups of the elements of value to a client. There are those elements which can be rewarded through a person's salary and keyed into a rate based upon time spent on an engagement. There are value elements which come from an accountant's technical achievements. These achievements may only be partially rewarded through a salary and are directly related to an accountant's skill and experience. Finally, there are those elements of value to a client which have little or nothing to do with the amount of time spent by the accountant on a particular engagement.[8]

Keeping in mind the idea of value, it is important to realize that the fee may be based to a large extent on

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[8] W. H. Morgan, "The Subjective Elements in a Fee," The Accountants' Journal (New Zealand), Vol. 52 (April, 1974), p. 345.

the technical importance of the work done for the client. What the level of technical importance is will be determined by relating the following six factors:

1. Level of work performed;
2. Sufficiency of records which support the work;
3. Proposed uses of the completed reports;
4. Dollar amounts involved;
5. Rules, regulations or requirements demanded by government agencies; and
6. Liability of the accountant to outside third parties.

The level of technical importance will have much to do with the size of the fee. Especially when considering the potential liability of accountants to third parties, it can be seen that a fee could be high. It is only reasonable that the fee charged would bear some relation to the risk involved, as well as to the importance of the services rendered.[9]

How does one determine the value or importance of the services rendered to a client? Many accountants use as an indication of value the savings that are made for the client as a result of the services. If considerable savings are shown to be achieved through the design and

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[9] _Ibid_.

installation of a new accounting system, or through the reduction of operating costs, or through savings in income taxes, this can bear a direct relation to a measure of the value of the services to the client. This may give a good indication of the fee to be charged.[10]

A further subjective component of any fee is the personal judgment of the accountant. In numerous situations, doing the correct thing may not be nearly as important as first being able to determine the correct course of action. This may require very little time, but in the judgment of the accountant, may be extremely valuable to the client. In determining the value of services to a client and using one's judgment, an accountant must consider the following three factors:

1. The intrinsic value to the client of the work performed
2. The degree of success in attaining the purpose for which the work was required
3. The purpose itself.[11]

By evaluating these three factors, an accountant can exercise his professional judgment in determining some portion of a client's fee.

Still another subjective component of a fee is the convenience to a client. It is hard to quantify this component, but it must be given some weight in determining a

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[10] Ibid.

[11] Ibid.

fee. When meetings are conducted in the accountant's office rather than on the premises of the client, the fees may be lower since a trip out of the office was avoided. Another facet of convenience to the client deals with when he requires his work to be done. If the work must be accomplished during a period of time when there is already an overload, rather than in a slack period, the fee to the client may be higher.[12]

Factors Leading to Fee Revision

The basic fee to a client is made up of the objective portion and the subjective portion discussed above. Once the basic fee is established, what factors can cause a fee to be revised? Generally fees are increased when a fee revision is contemplated. The reasons cited most often for an increase are the general economic environment, the long time elapsed since a prior fee adjustment, increased involvement in a client's affairs, and a change in a client's ownership structure, or diversification of a client's business interests.[13]

The general economic environment has been one of inflation over the past several years. This upward trend

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[12] Ibid., p. 346.

[13] Bernard B. Eder, "Fee Increases: When, How Much, and How?" The Practical Accountant, Vol. 7 (July/August, 1974), p. 26.

has caused increases in payroll expenses, fringe benefits, rent and all other costs of operating a business. This will create the need to revise a client's fee.[14]

In the case where a client has been receiving the services of an accounting firm for a number of years, it may have been a long time since any increase in fees has occurred. By comparing the increased cost of doing business with the situation that existed when a fee was initially established, the accountant may find it necessary to revise a fee.[15]

In many situations it becomes necessary for the accountant to become more involved in a client's business affairs. This may be due to new regulations of the government, to an increase in the volume of the client's business, or to an expanding of the facilities of a client and the need to modernize his accounting system. The evolvement of more complex accounting requirements within the accounting profession may cause increased involvement on the part of the accountant in a client's affairs. This increased involvement can lead to a fee increase.[16]

When a client's business undergoes a change in structure, either through a change in ownership or a change

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[14]Ibid., p. 28.

[15]Ibid.

[16]Ibid.

in the overall composition of the business, it is necessary for the accountant to devote more time to that client's particular problems. More research and management advisory services may be needed. This additional activity can cause a client's fee to increase.[17]

To determine a fee that is both reasonable and appropriate for each client, the accountant and the client need to remember the following key factors:

1. An auditor who has an adequate organization to perform the examination should be selected. An adequate organization would include auditors, specialists and office clerical staff.
2. The competence of the auditor's personnel and their ability to perform an audit of proper scope and in an economical manner should be reviewed.
3. The auditor should understand who the client is, the purpose of the examination, and with whom the arrangements are to be made. Written evidence should be made of these understandings.
4. The audit work to be performed should be planned and target dates set for the completion of specific phases of the audit.
5. Company [client's] personnel should be used for routine work where possible.
6. The auditor should discuss his findings as well as problem areas such as statement presentations and the wording of his opinion, with the president of the company.
7. Problems encountered during the audit should be reviewed and solutions should be found that will facilitate the audit of the following year.
8. Fees should be reviewed, especially when increases are proposed and they should be

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[17] *Ibid.*

compared with fees of other auditors, and those paid by comparable companies.

9. Separate detailed billings for special work and services performed outside the scope of the audit should be requested.
10. Management should maintain an annual review of the trend in audit fees, keeping in mind the growth of the company and the complexity of the business.[18]

Having examined the various aspects of determining a fee, what is the disadvantage of a policy of rotation of auditors as it affects fees? Basically, rotation of auditors is opposed because the use of new auditors on a job is more costly to the client than the use of the prior year's auditing firm. The fee for an initial audit of a client by an auditing firm is generally higher than for subsequent audits. This is due to the time involved. It has been estimated that it costs twice as much to perform the first audit as it does to carry out subsequent audits.[19]

The adverse effect which rotation of auditors has on a client's fee is closely tied to the adverse effect on another area--time.

Effect on Time

When a new auditor begins working with a client, he requires a great deal of time to gather a large amount

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[18] Thomas Fee, "Controlling the Audit Fee," _Management Accounting_, Vol. 56 (February, 1975), p. 49.

[19] N. Loyall McLaren, "Rotation of Auditors," _The Journal of Accountancy_, Vol. 106 (July, 1958), p. 43.

of information. This process is extremely time consuming.

Whenever an auditor is engaged by a client, he must plan his time in order to meet an important deadline. This deadline is the date set for making available to the board of directors and the stockholders the published financial statements. As a result of the additional time required to gather information on a first audit, the auditor may find himself pushed in terms of time available to get everything done. As a result of the time pressure, the auditor may not be able to perform the audit as thoroughly as it should be done. An auditor who has worked with the client in the past can generally make better use of the time available, especially in the areas of reviewing internal control, testing and discovering problems which need to be investigated.[20]

The overall effect on time of adopting a policy of rotation of auditors is to cause a greater amount of time to be spent on each new audit. Whenever a new firm of auditors is engaged by the client, this will cause more time to be spent by the auditors in gathering essential data, as well as more time to be spent by the client in supplying the needed data to a new firm of auditors.

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[20] Robert K. Mautz, "Rotation of Auditors," Financial Executive, Vol. 42 (July, 1974), p. 52.

Rotation of auditors will result in added costs to both the client and the auditor simply as a result of the additional time necessary on an initial audit. This effect on time involved ties directly in with the effect on fees previously discussed.

The third major area which is affected by the installation of new auditors in a client's business is efficiency.

Effect on Efficiency

The installation of new auditors can have adverse effects on the level of efficiency achieved during an audit engagement. When new auditors come into a client's office, it takes time to become acquainted with new procedures as well as with the client's personnel. Gaining certain necessary data may rely on successful communication with the client's staff. A new auditor may find it difficult at first to gain the complete cooperation of the client's staff. It is only human for this to happen. It takes time for the new auditor to get to know and communicate well with the client and his personnel. This failure to cooperate fully with a new auditor can cause the auditor's efficiency to be diminished.[21]

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[21] McLaren, "Rotation of Auditors," p. 43.

The level of efficiency at which an auditor performs on a given audit is related to the amount of knowledge which the auditor possesses about the client. When a new firm of auditors is installed, this level of efficiency is drastically reduced simply because the fund of previous knowledge about the client is zero. It takes time and effort to build up the knowledge as well as the level of efficiency in conducting an audit.

Not only the efficiency of the auditor but the overall efficiency of the client's business is affected when the auditors are new. It takes more time to give a new auditor the information he needs and to introduce him to the company procedures and personnel with whom he will be dealing. This time involved causes a disruption in the client's flow of work and consequently, an overall decrease in the effectiveness of the total operations of the client's business.

Even though a new auditor may bring new ideas into a client's office, it must be realized that a new auditor may also be less efficient and thorough. The installation of new auditors which would occur if a policy of rotation of auditors was adopted would cause many adverse effects for the clients as well as for the auditors. These adverse effects are seen mainly as increased fees, increased time spent on audits, and a reduced level of overall efficiency.

Experience and Information Loss from Previous Audits

The third disadvantage of rotation of auditors is the loss of experience and information from previous audits. This point is often discussed in the literature opposing a rotation policy. When a new auditor comes to a client, he has to build a fund of knowledge with regard to his client. He has lost the benefit which has been gained by the past auditor in terms of previous experience with the client and historical information upon which the past auditor would have been able to rely.

One way in which a new auditor might be able to overcome this loss of experience and information from previous audits is by relying on the work and reports of the previous auditor. However, he cannot rely on this previous work to the extent of accepting it at face value. The new auditor must satisfy himself as to the beginning account balances and as to the consistent application of generally accepted accounting principles. Even though the new auditor communicates with the predecessor auditor, the new auditor cannot relieve himself of the responsibility for the previous work simply by referring to the previous auditor's work and report.[22]

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[22]Dennis S. Neier, "Using the Work and Reports of Other Auditors," The New York Certified Public Accountant, Vol. 41 (October, 1971), p. 725.

In October of 1975, the Auditing Standards Executive Committee issued Statement on Auditing Standards No. 7 entitled "Communications Between Predecessor and Successor Auditors." This statement was issued as a means of providing the accounting profession with guidelines for communication between a predecessor and a successor auditor. This statement discusses two types of communication. The first type of communication is communication before a successor accepts the engagement, and the second is communication between a predecessor and a successor auditor after acceptance of an engagement.[23]

After an auditor accepts an engagement, the successor auditor may find it necessary to inquire specifically about items which he feels may affect the performance of his audit. Such items might include certain areas which need a great deal of time to explore or particular audit problems that materialized as a result of the client's accounting system and records. In addition, the successor auditor may review the predecessor's working papers. The procedure for this step is clearly outlined in the Statement on Auditing Standards No. 7 as follows:

> The successor auditor should request the client to authorize the predecessor to allow a review of the predecessor's working papers. It is

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[23] _Statement on Auditing Standards No. 7: Communications Between Predecessor and Successor Auditors_ (New York: American Institute of Certified Public Accountants, Inc., 1975), pp. 2-3.

> customary in such circumstances for the predecessor auditor to make himself available to the successor auditor for consultation and to make available for review certain of his working papers. The predecessor and successor auditors should agree on those working papers that are to be made available for review and those that may be copied. Ordinarily, the predecessor should permit the successor to review working papers relating to matters of continuing accounting significance, such as the working paper analysis of balance sheet accounts, both current and noncurrent, and those relating to contingencies.[24]

By following these guidelines, a successor auditor may be able to overcome some of the loss of information which is experienced when a change in auditors takes place. However, this communication will not completely make up for the loss of information and for the experience loss. The experience gained by a continuing relationship between an auditor and a client can be of invaluable benefit to a client. A background of information and experience is built up between the client and the auditor which enables the auditor to offer sound advice about the operations, procedures and controls of the client's operations.[25]

The experience and information loss from previous audits which is a big disadvantage of a policy of rotating

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[24] _Ibid._, p. 3.

[25] Alan J. Winters, "Looking at the Auditor Rotation Issue," _Management Accounting_, Vol. 57 (March, 1976), p. 30.

auditors is closely associated with a fourth disadvantage, the disruption of the services offered to a client.

Disruption of Services Offered to a Client

Another disadvantage that is often discussed in connection with the loss of experience and information is the general disruption of the services offered to a particular client.

Many clients do not want a change in the auditor who performs their particular audit. They feel that the experience and information gathered about the problems and overall operations of the company enable the auditor to conduct a better audit. In addition to performing a better audit, the accountant is in a better position to offer advice on taxes, system design, Securities and Exchange Commission work and management advising.[26]

The quality of the services rendered to a client could be less if auditors were rotated. The mere disruption of services, coupled with information and experience loss, could provide the client with a level of work of inferior quality rather than one of excellent quality, even though the audit and other services are conducted from a fresh point of view. The auditor who has had a long, continuous working relationship with a client is the one who

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[26] McLaren, "Rotation of Auditors," p. 43.

is best capable of offering help and advice to management in all of the areas in which the accounting profession provides services, from auditing to management advisory services. The disruption of these services for the client would hardly seem to serve much benefit.

Summary

When examining any proposal, it is necessary to discuss both the positive points and the negative points. This chapter has presented and discussed the disadvantages of adopting a policy of rotation of auditors within the profession. The first disadvantage is the loss of large clients by CPA firms. The second disadvantage is the adverse effects which are experienced when new auditors are installed. These adverse effects are evident in the areas of fees, time, and efficiency. A third disadvantage is the loss of experience and information from previous audits. A fourth disadvantage is the disruption in the overall services which are offered to a client. Having discussed the advantages of rotation of auditors in the preceding chapter and the disadvantages of rotation of auditors in this chapter, the following chapter will present the results of a survey in which the general practices of selecting, rotating, and retaining auditors are explored.

Chapter 4

THE RESULTS OF THE QUESTIONNAIRES

This chapter presents the results of the questionnaires mailed to the controllers of the United States largest industrials and to CPA firms. As explained in Chapter 1, the questionnaire for controllers was mailed to each of the companies in the *Fortune* 500 listing. The questionnaire for CPA firms was mailed to a partner in the main office of each of the "Big 8" and "Big 7" firms.

This chapter will be divided into two main sections. The first section will discuss the results of the questionnaire to controllers. The second section will discuss the results of the questionnaire to CPA firms.

Responses of the Controllers

Of the 500 questionnaires which were sent to the controllers of the *Fortune* 500 companies, 339 responded, which was a 67.80% response rate. Of the 339, four companies stated that they could not participate. Therefore, the following data which are presented are based on the 335 useable responses.

Selection of the Auditor

The first three questions of the questionnaire dealt with the area of selection of the auditor. The first question asked whether the company had an audit committee. Of the 335 respondents, 315 (94.03%) companies indicated they did have an audit committee, while 20 (5.97%) companies indicated they did not. The formation of audit committees to help the company deal with independent auditors has received more and more attention over the last several years. It is not surprising that 94.03% of the respondent companies have audit committees. By June 30, 1978, all domestic companies who list their common stock on the New York Stock Exchange must have audit committees formed.[1]

The second question asked whether the audit committee selected the outside CPA firm. Of the 335 respondents, 193 (57.61%) said yes; 136 (40.60%) said no; a few (6, 1.79%) did not answer the question. Since one of the main functions of the audit committee is to help in selecting the outside CPA firm, these results agree with most of the literature written on the functions of the audit committee.

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[1] R. K. Mautz and F. L. Neumann, Corporate Audit Committees: Policies and Practices (Altamonte Springs, Florida: The Institute of Internal Auditors, Inc., 1977), p. 19.

The third question asked the respondent the following question: "If the answer to #2 is No, then who does select the CPA firm to perform the annual audit?" This question, coupled with the previous question, caused many of the respondents to explain the selection process of the auditor in which the company engaged. Of the 193 respondents who indicated that the audit committee selected the CPA firm, 29 of them also answered question 3 as a means of further explanation. The 136 who answered "no" to question 2 gave several different procedures followed for selecting the auditor in answer to question 3. Table 1 on page 96 presents the various procedures of all of the 335 respondents. As the table indicates, there are many different procedures for selecting the outside independent CPA firm to perform the annual audit.

Retention of the Auditor

The results of question 4 showed a wide range of answers to the number of years that the present auditing firm had been auditing the company. There are 56 (16.72%) firms of the 335 respondents which have had the same auditing firm for 50 years or more. Table 2 on page 97 shows the overall responses of the companies to this question which range from less than one year to 80 years.

Table 1

PROCEDURE FOR AUDITOR SELECTION

Procedure	Number	Percent
Board of Directors recommends; Stockholders approve	15	4.48
Management recommends; Board of Directors selects	5	1.49
Shareholders select	22	6.57
Board of Directors selects	25	7.46
Management selects	9	2.68
Management recommends; Stockholders ratify	2	0.60
Management and audit committee select	13	3.88
Management recommends to audit committee who recommends to Board of Directors who selects	1	0.30
Management recommends to audit committee who recommends to Board of Directors who recommends to Stockholders who approve	1	0.30
Executive committee selects	1	0.30
Parent company selects	1	0.30
Audit committee recommends to Board of Directors who select	21	6.27
Controller selects with the approval of the audit committee	1	0.30
Audit committee recommends to Board of Directors who approve and present the selection to the Stockholders for final approval	27	8.06
Audit committee recommends; Stockholders approve	20	5.97
Audit committee selects	164	48.95
No method stated other than "not the audit committee"	1	0.30
No answer	6	1.79
Total	335	100.00

Table 2

RETENTION OF THE PRESENT AUDITING FIRM

Years Retained	Companies		Years Retained	Companies		Years Retained	Companies		Years Retained	Companies	
	#	%		#	%		#	%		#	%
Less than 1	13	3.88	21	2	0.60	42	0	0.00	63	0	0.00
1	6	1.79	22	3	0.90	43	1	0.30	64	0	0.00
2	4	1.19	23	2	0.60	44	2	0.60	65	1	0.30
3	6	1.79	24	2	0.60	45	9	2.68	66	0	0.00
4	4	1.19	25	28	8.36	46	1	0.30	67	1	0.30
5	6	1.79	26	1	0.30	47	0	0.00	68	1	0.30
6	1	0.30	27	3	0.90	48	3	0.90	69	0	0.00
7	4	1.19	28	5	1.49	49	0	0.00	70	4	1.19
8	4	1.19	29	1	0.30	50	23	6.86	71	1	0.30
9	3	0.90	30	31	9.25	51	1	0.30	72	0	0.00
10	18	5.36	31	2	0.60	52	2	0.60	73	1	0.30
11	3	0.90	32	1	0.30	53	0	0.00	74	0	0.00
12	4	1.19	33	3	0.90	54	1	0.30	75	3	0.90
13	2	0.60	34	3	0.90	55	0	0.00	76	0	0.00
14	3	0.90	35	7	2.08	56	1	0.30	77	1	0.30
15	18	5.36	36	1	0.30	57	1	0.30	78	0	0.00
16	2	0.60	37	1	0.30	58	2	0.60	79	0	0.00
17	4	1.19	38	1	0.30	59	1	0.30	80	2	0.60
18	3	0.90	39	0	0.00	60	6	1.79	No useable answer	7	2.08
19	0	0.00	40	20	5.97	61	1	0.30			
20	30	8.95	41	1	0.30	62	2	0.60			
									Total	335	100.00

Rotation of the Auditor

The remaining questions on the questionnaire explored the present practices of the companies as to the rotation of auditing firms as well as the opinions of the controllers concerning the rotation of auditors.

The fifth and sixth questions asked the company whether it changed auditing firms on a regular basis and if so, how often. Of the 335 respondents, 327 (97.61%) answered no; 5 (1.49%) answered yes; and 3 (0.90%) gave no answer. Of the five that answered yes, two companies indicated that they changed auditing firms every 3 to 5 years; two companies changed auditing firms on a basis of more than 5 years; and one firm gave no answer as to how frequently a change took place.

The seventh question asked the controller whether he felt that an auditor may become lax in his approach to the audit engagement of the same company over a period of years. A majority of the respondents, 290 (86.57%), felt that this would not be a problem. Only 36 (10.75%) agreed that this might be a problem. There were 9 (2.68%) who gave no answer.

The eighth question asked the controller for his opinion concerning an auditor's independence after being with the same corporation for a period of years. There were 306 (91.34%) respondents who felt that an auditor would not be considered less than independent after a

period of years with the same client-corporation. Only 24 (7.17%) felt that there would be a problem concerning the auditor's independence. Five respondents (1.49%) gave no answer.

The ninth and tenth questions were related. The controller was asked whether he favored a policy of automatically changing independent auditing firms on a routine basis. If he answered yes, he was asked how often they should be changed. The results of this question show that an overwhelming number of respondents (322, 96.12%) are against this policy. A small number (10, 2.99%) are in favor of the policy. A few respondents (3, 0.89%) failed to answer the question. Of the 10 who answered that they did favor a policy of automatically changing independent auditing firms on a routine basis, 4 respondents favored a policy of changing every 3 to 5 years and 6 respondents favored a policy of using a basis of more than 5 years.

The eleventh and twelfth questions explored the controllers' feelings about whether by changing auditors on a routine basis, they felt the company would be provided with a more objective evaluation of their accounting system and financial statements. The respondents were asked to explain why they felt as they did. The majority of the respondents (310, 92.54%) did not feel that a change in auditors would provide a company with a more objective evaluation. Only 18 (5.37%) respondents felt that by

changing auditors, a more objective evaluation would be achieved. Seven (2.09%) respondents gave no answer. When asked why they felt as they did, the 310 respondents, who answered no to the preceding question, gave several different reasons. These reasons are presented in Table 3 on page 101. The results agree with several of the disadvantages of the rotation of auditors which were discussed in Chapter 3.

The following responses are representative of the type of opinions which are grouped in Table 3 as "other comments":

> The objective evaluation of an accounting system depends on the ability and integrity of the accounting firm performing the audit. This is not necessarily improved by routine rotation.
>
> The professional auditor is objective by definition - if this were to be questioned, then the entire system should be discarded.
>
> CPA firms are no different than other professionals. Should people change doctors (M.D.'s) or lawyers periodically? Change does not insure objectivity.

There were a total of 18 (5.37%) respondents who agreed that changing auditors was worthwhile. Their main reason for agreeing was that they felt that rotation would provide a greater degree of independence and a fresh point of view. Of the 18 respondents, 11 (61.11%) stated this opinion. The remaining 7 (38.89%) respondents expressed their opinions a little differently. The following four opinions express some of the areas of concern which arise

Table 3

VIEWS EXPRESSED AGAINST ROTATION

View	Number	Percent
Auditors rotate within the firm on a job and supply a fresh point of view, maintain their independence and overcome the problem of laxness	132	42.58
Rotation would require too much time and money to be spent educating a new auditing firm to the procedures of the company	29	9.35
A higher quality audit is performed by an auditing firm who has a complete understanding of the company and can provide the insight of many years of association with the company and its problems. Continuity is more valuable than change.	54	17.42
The professional standards of the accounting profession and the possibility of peer reviews as well as pressure of potential litigation are enough to assure independence and a high quality audit.	6	1.94
Other comments	46	14.84
No opinion	43	13.87
Total	310	100.00

when auditing firms continue in long associations with clients:

> Work becomes routine; opinions are formed over a period of time that could tend to limit objectivity.
>
> Normally a firm becomes stale in their approach if they remain too long. They begin to assume too much and become comfortable with the client's staff.
>
> A CPA firm would tend to be more assertive in its observation if it knew another firm would be "looking over their shoulders" the next year or so.
>
> Currently, I think managements have a tendency to influence auditing firms, primarily because of the revenues involved to the auditing firms.

The opinions of the 18 respondents who favored rotation express several of the advantages of rotation of auditors which were discussed in Chapter 2.

The last specific question of the survey asked the respondent to answer the following: "Do you foresee any change which your corporation will make in the future with regard to the policy of selecting the independent CPA firm?" The majority of the respondents (295, 88.06%) replied no; 25 (7.46%) replied yes; and 15 (4.48%) gave no answer. Of the 25 respondents who indicated a change in the future, some further explained what the change might be. Two of these possible changes were given as follows:

> If the authorities and the public continue to question independence of CPAs, some rotation of firms probably will be required.

> It's possible that we would consider throwing the audit open to bid each 5 years or so to ensure price competitiveness.

The final part of the questionnaire invited the respondents to make additional comments. Of the 335 respondents, only 17 (5.07%) participated further. All of the 17 respondents were opposed to a policy of rotation of auditors. Two comments in particular summarize the majority viewpoint which does not favor a policy of rotation of auditors. One controller remarked:

> Rotation of firms is expensive and not the answer. The answer is the background and capability of the audit partner and of the staff. The second answer is to have a well-trained, well qualified, well-paid accounting department. Management cannot escape responsibility by blaming auditors.

Another controller concluded:

> Companies that use the services of small firms might do well to change (rotate) auditors from time to time since smaller auditing firms may not be able to rotate <u>personnel</u> on the account so easily. The pressure (presumably coming from the government regulatory agencies and possibly academia) to have mandatory rotation of independent public accountants smacks of the usual unfortunate suspicions that the "public sector" seem to harbour with respect to the "private sector." It completely ignores the fact that the major characteristic, other than competence, that public accountants have to offer is integrity and independence. It is in their own best interests to maintain that posture and the good ones do. The costs of replacing auditors because of the time it takes for new firms to become acquainted with individual company procedures more than offsets the potential benefit to shareholders - and the public - unless there have been some "sweetheart" deals - but sweetheart deals are not in the best interest in the long run of the accounting

> firms. Furthermore, auditing firms who _know_ the business and the client and _are still independent_ are more likely to be of greater help to their client by virtue of their superior knowledge of the company.

Cross Analyses

Some interesting cross analyses follow. Of the 328 (97.91%) respondents who indicated the number of years that the present auditing firm had been auditing the company, 319 of those answered whether or not they felt that an auditor may become lax in his approach to the audit engagement of the same company over a period of years. Of the 319, 284 (89.03%) felt that this would not occur. However, 35 (10.97%) indicated that laxness might occur. Table 4 on page 105 shows how many years the same firm has audited the company where the controller felt that laxness might have occurred. It is interesting to note that the remaining 284 respondents to the question dealing with an auditor's laxness have had the same auditing firm for periods of less than a year up to periods of 80 years. No respondent whose company has had the same auditing firm for more than 52 years, i.e., 30 companies, felt that laxness was a problem.

Another cross analysis was drawn between the number of years that the same auditing firm had been auditing the company and the opinion of the controller as to whether the auditor may be considered to be less than independent after a period of years. Although 24 (7.16%) respondents of the

Table 4

YEARS OF SERVICE BY SAME FIRM COUPLED WITH POSSIBLE LAXNESS

Years of Service	Number of Controllers Who Feel Laxness May Become a Problem	
	Number	Percent
Less than 1 Year	3	8.57
1	2	5.71
10	1	2.86
15	2	5.71
18	1	2.86
20	2	5.71
25	4	11.42
26	1	2.86
28	1	2.86
29	1	2.86
30	3	8.57
32	1	2.86
34	1	2.86
38	1	2.86
40	3	8.57
45	1	2.86
48	1	2.86
50	5	14.28
52	1	2.86
Total	35	100.00

335 felt that independence might be a problem, only 23 of these gave an answer as to how many years the same firm had been auditing the company. Table 5 on page 107 summarizes the results of this cross analysis. As in the previous cross analysis, the majority of the firms feel that after a period of years with the same corporation, an auditor will not be considered less than independent. Even the 30 companies who have had their same auditing firm in excess of 52 years do not feel that the independence issue is a problem.

Responses of the CPAs

A questionnaire was mailed to one partner in the main office of each of the accounting firms known as the "Big 8" and the "Big 7." The response rate of the questionnaire was 66.67%, totaling 10 useable responses.

Selection of the Auditor

The first four questions of the CPA questionnaire dealt with the area of selection of the auditing firm. The first question asked what percentage of the corporations that the CPA firm audited had audit committees. Of the 10 respondents, 2 (20%) said 50%; 1 (10%) said 5%; 1 (10%) said 20%; 1 (10% said less than 1%; and 1 (10%) indicated that more than 80% of his clients had audit committees. Four (40%) respondents stated that no information was available in answer to this question.

Table 5

YEARS OF SERVICE BY SAME FIRM COUPLED WITH POSSIBLE LOSS OF INDEPENDENCE

Years of Service	Number of Controllers Who Feel Loss of Independence May Become a Problem	
	Number	Percent
Less than 1 Year	3	13.04
1	1	4.35
2	1	4.35
5	1	4.35
20	1	4.35
25	3	13.04
30	2	8.69
32	1	4.35
34	1	4.35
40	2	8.69
45	1	4.35
48	1	4.35
50	4	17.39
52	1	4.35
Total	23	100.00

In the second question, the respondents were to indicate whether or not the audit committee, if the company had one, selected the outside CPA firm. One (10%) respondent indicated yes and 3 (30%) said no. The information was unavailable from one respondent. The remaining 5 (50%) gave the following explanations:

Two (20%) replied:

> It [the audit committee] generally plays an important role.

Two (20%) said:

> Some do; most do not.

One (10%) commented:

> Seems to be a movement toward selection by audit committees.

The respondents were questioned next as to who did select the CPA firm in corporations that had audit committees but whose audit committee did not make the selection. Seven (70%) respondents who supplied information to this question outlined several methods of auditor selection. One said the Board of Directors made the choice; two said management did; one said the Board of Directors or stockholders did. The remaining three gave the following responses:

> Management recommends and the audit committee approves.
>
> The chief executive officer selects with the approval of the Board of Directors.
>
> The audit committee recommends but the Board of Directors appoints the auditor.

The other three respondents gave no answer to this question.

The fourth question asked the respondents to indicate who did select the CPA firm in corporations where there was no audit committee. Table 6 below summarizes the responses.

Table 6

PROCEDURES FOR AUDITOR SELECTION WHERE NO AUDIT COMMITTEE EXISTS

Procedure	Number	Percent
Chief Executive selects	3	30
Management, Board of Directors or Stockholders select	1	10
Management selects	3	30
Management or Board of Directors selects	2	20
No information available	1	10
Total	10	100

Rotation of Auditing Firms

The next several questions explored the area of rotation of auditing firms. The CPAs were asked whether their clients had a tendency to change auditing firms on a regular basis. All of the respondents indicated no. No client followed a policy of regularly changing or rotating the audit firm which performed the annual audit.

The CPAs were asked how often their clients change audit firms. Of the ten respondents, 4 (40%) stated a period of more than five years; 4 (40%) gave no answer, and 1 (10%) stated that there was no found pattern.

Rotation Practices Within Auditing Firms

The next section of the questionnaire explored the practices of rotation which the CPA firms engaged in within their individual firms. There is a policy of rotating on a periodic basis the staff assistants on a given client's audit in 6 (60%) of the CPA firms surveyed. The remaining 4 (40%) do not. Of the firms that do rotate staff assistants, one does it every two years; two do it every five years; another does it every two to five years; one limits continuous service; and one firm gave no answer as to how often rotation occurs.

There are 6 (60%) of the CPA firms that follow a policy of rotating on a periodic basis the senior accountant on a given client's audit. Four (40%) do not. The six firms that have this policy rotate the senior accountant as follows: two said every 3 years; two said every 5 years; one said every 2 to 5 years; and one indicated limiting continuous service.

Those firms that follow a policy of rotating the manager in charge of a given client's audit number 6 (60%). Those that do not, number 4 (40%). Of the six that do, four indicated rotation every 5 years; one said every 3 years; and one said every 3 to 5 years.

The pattern of responses to the preceding three sets of questions changes slightly with the next question. The question is as follows: "Is there a policy of rotating

the partner in charge of a given client's audit?" Of the 10 respondents, 8 (80%) said yes; 2 (20%) said no. Of the 8 that said yes, 7 firms change the partner in charge every 5 years, and 1 firms changes every 5 to 7 years.

Views on Rotation of Auditing Firms

The last part of the questionnaire sent to the CPAs asked several questions directed at determining their views on a policy of compulsory rotation of CPA firms among clients.

The first question posed was as follows: "In light of the Metcalf Report and the proceedings of the Senate Subcommittee with regard to studying how to improve accounting and auditing, it is necessary for the accounting profession to take some measures toward self-regulation. With this in mind, do you feel that the future may hold a policy of compulsory rotation of CPA firms among clients?" Of the 10 respondents, 2 (20%) said yes; 8 (80%) said no.

The next two questions asked the respondents whether they felt that such a policy would increase an auditor's independence and would cause an auditor to be more objective in his dealings with clients. In answer to these two questions, 1 (10%) said yes, and 9 (90%) said no.

The final question asked the respondents to indicate how they felt about a policy of rotating auditing firms among clients on a routine basis. The responses to this question are listed below:

It would be expensive and counterproductive. Same result can be achieved by rotating people.

Doesn't make economic sense for any company - the extra cost of rotation will have to be passed on to all clients without apparent benefit.

Negative: too costly for client. Positive and better results can be obtained by rotating partners on the engagement.

Disagree. Increase costs without offsetting benefits.

Opposed.

See no advantages. Whatever is proposed to be gained by rotating firms can be obtained as effectively and far more economically by other means.

Would be more costly and would not improve performance.

It would raise the costs and reduce the efficiency of audits and would increase auditor independence only in appearance.

We believe such a policy would be counterproductive.

Rotation of independent auditors among clients would not increase an auditor's independence or objectivity; however, increasing responsibility for the independent auditors and their selection should be placed on the audit committee.

Summary and concluding remarks of this author are presented in Chapter 5.

Chapter 5

SUMMARY AND CONCLUSIONS

A brief summary of this study is given in this chapter. Concluding remarks follow this summary, as well as suggestions of areas for additional research.

Summary of This Study

The objectives of this study are threefold: (1) to examine the advantages and disadvantages of the rotation of auditors, (2) to survey accountants in public practice and controllers in industry for their opinions on a policy of rotation of auditors, and (3) to examine the results of the survey and determine whether or not the accounting profession should adopt a policy requiring rotation of auditors.

This study began with a literature search to determine what were considered to be the advantages and disadvantages of the rotation of auditors. The advantages of a policy of rotation of auditors are the maintenance of independence, the provision of a fresh point of view, and the possible reduction of litigation against accountants. The disadvantages of a policy of rotation are the possible loss of large clients by CPA firms, the adverse effects of

installing new auditors, the experience and information loss from previous audits, and the disruption of services offered to a client. This discussion, presented in Chapters 2 and 3, helped to clarify both sides of the issue of rotation of auditors, thereby accomplishing the first objective.

The results of a survey of accountants and controllers were presented in Chapter 4, fulfilling the second and third objectives. Two questionnaires, exploring the selection, rotation, and retention of independent auditors, were sent--one to a group of accountants and another to a group of controllers. The controllers of the "*Fortune* 500 companies" were asked to respond to one questionnaire. The total responses were 339, for a 67.8% response rate. The group of accountants surveyed was composed of a partner in each of the main offices of the "Big 8" and the "Big 7" CPA firms. The total responses were ten, for a 66.67% response rate. The majority of the controllers (310 or 92.54%) did not feel that by changing auditors on a routine basis, their company would be provided with a more objective evaluation of its accounting system and financial statements. The main reason for this response was that controllers felt that rotation within the CPA firm provided a fresh point of view, maintained independence and reduced laxness on the part of the CPAs. The CPAs agreed with the controllers. Of the CPA respondents, nine (90%) did not

feel that a policy of rotation would cause an auditor to be more objective in his dealings with clients. The main reason given by CPAs for opposing rotation is that they feel that such a procedure would be too costly and would be counterproductive.

Conclusions of This Study

The topic of rotation of auditors has long been a controversial issue. For more than twenty years, articles have appeared in various professional journals discussing the advantages and disadvantages of a policy of rotation of auditors. The concluding viewpoint of all of these articles is that rotation of auditors is not a reasonable procedure to be implemented within the accounting profession.

The recent interest which has been generated about the topic of rotation of auditors is a result of the investigation by the United States Senate Subcommittee on Reports, Accounting and Management which published its findings in March 1977. In the list of recommendations given in the study, the fourth recommendation discusses the possibility of mandatory rotation as follows:

> Congress should consider methods of increasing competition among accounting firms for selection as independent auditors for major corporations. At present, a single accounting firm, nominated by management, is placed on the ballot of annual meetings of stockholders. Domination of the corporate election process by large institutional investors and management ensures that the accounting firm

> nominated by management is elected. Long association between a corporation and an accounting firm may lead to such close identification of the accounting firm with the interests of its client's management that truly independent action by the accounting firm becomes difficult.
>
> One alternative is mandatory change of accountants after a given period of years, or after any finding by the SEC that the accounting firm failed to exercise independent action to protect investors and the public.[1]

The current interest being exhibited regarding the regulation of the accounting profession by the SEC, the government and the profession itself would possibly cause the profession and the business world to consider a policy of rotation of auditors, that is, auditing firms. The results of the empirical research done in this study indicate however that neither the largest representative firms of the accounting profession, the "Big 8" and the "Big 7," nor the controllers of the largest United States industrial companies are receptive to a policy of mandatory rotation of auditors. Only 5.37% (18) of the controllers felt that a policy of rotation would provide auditors who would achieve a more objective evaluation of their company, by providing a fresh point of view and a greater degree of independence from management. Only one CPA felt that a

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[1] U. S., Congress, Senate, Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, The Accounting Establishment: A Staff Report, S. Doc. No. 95-34, 95th Congress, 1st Session, 1977 (Washington, D. C.: Government Printing Office, 1977), p. 21.

policy of rotation would cause an auditor to be more objective in his dealings with clients. Both sets of respondents, the controllers and the CPAs, feel that mandatory rotation would be too costly and disruptive. The majority of opinions from both groups indicate that another method other than mandatory rotation can be used to achieve greater independence and a fresh, more objective point of view. They are satisfied with the current practice of internal rotation of accountants working on a client's audit that is presently practiced by CPA firms.

While the practice of internal staff rotation is part of a plan of self-regulation for the profession, this author feels that this practice falls short of the type of regulation which the United States Senate Subcommittee on Reports, Accounting and Management is suggesting. Although mandatory rotation is only one possibility of regulating the profession, it is a possibility which should be given greater attention by the business sector and the profession. The business sector and the accounting profession cannot ignore such a policy as rotation of auditors simply because it is, in their opinion, basically too expensive to institute.

Areas for Additional Research

In examining the policy of rotation of auditors as a means of self-regulation by the accounting profession, it becomes evident that this is still a very controversial

topic. Even though the business sector and the profession are against the policy of mandatory rotation, this does not mean that such a policy may not be adopted in the future. The pressures from the government and society in general are being brought to bear on the accounting profession, as well as the business sector, with regard to accounting practices and procedures. These pressures cannot be ignored. The accounting profession may find itself adopting a policy of mandatory rotation of auditors as a result of a ruling by the SEC or by Congress. The accounting profession should open its eyes to such a possibility rather than assuming that the policy of mandatory rotation will fade away simply because the accounting profession is against it.

In several recent articles published in professional journals and newsletters, the idea of self-regulation by the accounting profession has been discussed. Wallace Olson, president of the American Institute of Certified Public Accountants, in a recent article in the Journal of Accountancy, discussed the new division of firms within the AICPA and the range of sanctions that can be imposed on those firms. However, he also pointed out the problem facing the profession in the following comments:

> To sum up, the outlook is for more disciplinary machinery, not less. The question of whether a new federal regulatory scheme will be established through legislation hangs in the bal-

> ance, pending an appraisal of the effectiveness of the AICPA division of firms.
>
> . . . .
>
> It will be a major achievement if the profession's actions toward self-regulation prove to be successful in convincing its critics that additional governmental regulation is unnecessary.[2]

Recent statements by SEC chairman Harold Williams indicate that the matter of the accounting profession's practices and procedures are becoming of more and more interest to the SEC. Mr. Williams has been stressing the need for stronger internal auditors as well as stronger audit committees. With regard to self-regulation by the accounting profession, Mr. Williams recently issued a report to the U. S. Congress on the profession's efforts in this area. In a recent meeting with the AICPA council, Mr. Williams stated that the profession's program would be examined by looking at the issues of independence, quality control, including self-discipline, and the accounting and auditing standard-setting process. In his opinion, the profession's program can satisfy Congress and the SEC provided that the public oversight board, established in the AICPA self-regulatory program, is truly independent.[3]

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[2]Wallace E. Olson, "How Should a Profession Be Disciplined?" The Journal of Accountancy, Vol. 145 (May, 1978), pp. 65-66.

[3]"SEC Chairman's Report to Congress," The Journal of Accountancy, Vol. 146 (July, 1978), p. 3.

Further possibility of regulation imposed upon the profession is evidenced by the recent bill introduced into the House of Representatives by Representative John E. Moss. The bill would establish a National Organization of SEC Accountancy. The organization would have a five person SEC appointed board which would investigate auditors and take disciplinary action against auditing firms and individual auditors.[4] If this bill is passed, the regulatory pressures felt by the accounting profession will be even greater than before.

It would be better for the accounting profession to implement a policy of rotation of auditors voluntarily rather than have such a policy imposed upon the profession by an outside agency, be it the United States Congress or the SEC. Further discussion and research is needed in the area of the applicability of a rotation policy to the business sector as well as in the area of the actual implementation of a policy of mandatory rotation.

Research efforts should be directed toward investigating any effort at rotation of auditing firms which have been instituted to determine what the result of such plans have been. Even though the research which was done by this author did not indicate any such plans for rotation

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[4]"Moss Proposes a 'National Organization of SEC Accountancy,'" The Journal of Accountancy, Vol. 146 (July, 1978), p. 3.

being considered by the large industrials, it is possible that such rotation policies are carried out by smaller companies. Some cities have policies for rotating the auditing firm which audits their city government agencies. The City of Wichita in Kansas has a policy of rotating the auditing firm every three years, which has been carried out successfully for several years.[5] By examining the policies of rotation of auditors by city governments, research may reveal ways in which a mandatory system of rotation of auditors could be effectively implemented by the accounting profession.

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[5]"Rotation and Selection of External Auditing Firms," The Internal Auditor (November/December, 1973), p. 94.

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APPENDIX A

The Questionnaires

Appendix A presents the questionnaires mailed in this study. It contains the transmittal letters to the controllers and the CPAs, and the two questionnaires that were sent to the controllers and the CPAs.

MEMPHIS STATE UNIVERSITY
College of Business Administration—BA 200
MEMPHIS, TENNESSEE 38152

Department of Accountancy

February 27, 1978

Dear Controller:

The improving of accounting and auditing for all clients is a common goal of all professional accountants. Recently there has been a great deal of concern about federal controls being placed on the profession as a way to improve accounting and auditing.

In an effort to determine ways in which the accounting profession can provide better service to its clients without federal intervention, my doctoral dissertation from Louisiana State University is exploring the area of "Selection, Rotation and Retention of Independent Auditors." Since the opinions of those who use independent auditors will have a bearing on the future of the profession, I must come to you to ask your opinion on this topic. By answering the enclosed questionnaire you will be supplying important information as to whether the users of independent auditors feel that services to their firm might be improved.

Your individual responses to the questions will be kept confidential. The number on the questionnaire is for follow-up purposes only. A return, postage-paid envelope is enclosed for your convenience.

If you would kindly take the time now from your busy schedule and answer the enclosed questionnaire and return it before March 15, 1978, I would greatly appreciate your time and effort.

Sincerely,

Mrs. Sarah C. Dawkins
Assistant Professor of
Accountancy

SCD/ds
ENCLOSURE

A QUESTIONNAIRE CONCERNING THE

SELECTION, ROTATION AND RETENTION OF INDEPENDENT AUDITORS

1. Does your corporation have an audit committee? Yes____ No____

2. Does the audit committee select the outside C.P.A. firm? Yes____ No____

3. If the answer to #2 is No, then who does select the C.P.A. firm to perform the annual audit? ____________________

4. How long has the present auditing firm been auditing your corporation? ____years

5. Does your corporation change auditing firms on a regular basis? Yes____ No____

6. If yes, how regularly? Every 1-2 years? ________
   Every 3-5 years? ________
   More than 5 years ________

7. Do you feel that an auditor may become lax in his approach to the audit engagement of the same company over a period of years? Yes____ No ____

8. Do you feel that after a period of years with the same corporation as a client, an auditor may be considered less than independent? Yes____ No ____

9. Do you favor a policy of automatically changing independent auditing firms on a routine basis? Yes____ No____

10. If yes, how often should they be changed? Every 1-2 years? _______
    3-5 years? _______
    More than 5 years? _____

11. Do you feel that by changing auditors on a routine basis your corporation would be provided with a more objective evaluation of your accounting system and financial statements? Yes____ No ____

12. Why do you feel as you do?

13. Do you foresee any change which your corporation will make in the future with regard to the policy of selecting the independent C.P.A. firm?

14. Please use the back of this page to make any further comments.

Return to: Mrs. Sarah C. Dawkins, Department of Accountancy, Room 200, College of Business Administration, Memphis State University, Memphis, Tennessee 38152

MEMPHIS STATE UNIVERSITY
College of Business Administration—BA 200
MEMPHIS, TENNESSEE 38152

Department of Accountancy

March 10, 1978

Dear CPA:

The improving of accounting and auditing for all clients is a common goal of all professional accountants. Recently there has been a great deal of concern about federal controls being placed on the profession as a way to improve accounting and auditing.

In an effort to determine ways in which the accounting profession can provide better service to its clients without federal intervention, my doctoral dissertation from Louisiana State University is exploring the area of "Selection, Rotation and Retention of Independent Auditors." Since the opinions of those who render services to clients will determine the future actions of the profession as a whole, I must come to you to ask your opinion on this topic. By answering the enclosed questionnaire you will be supplying important information as to how services to clients can be better improved.

Your individual responses to the questions will be kept confidential. The number on the questionnaire is for follow-up purposes only. A return, postage-paid envelope is enclosed for your convenience.

If you would kindly take the time now from your busy schedule and answer the enclosed questionaire and return it before April 1, 1978. I would greatly appreciate your time and effort.

Sincerely,

Mrs. Sarah C. Dawkins
Assistant Professor of
Accountancy

A QUESTIONNAIRE CONCERNING THE

SELECTION, ROTATION AND RETENTION OF INDEPENDENT AUDITORS

1. What percentage of the corporations that you audit have audit committees?______

2. In the corporations that have audit committees, does the audit committee select the outside independent C.P.A. firm to perform the annual audit? Yes____ No______

3. If the answer to #2 is No, who does select the outside C.P.A. firm?________________

4. In corporations that do not have an audit committee, who selected your firm as the independent C.P.A. firm?____

5. Do your clients have a tendency to change auditing firms on a regular basis? Yes___________________No_________________

6. If yes, how many clients follow a policy of regularly changing or rotating the audit firm which performs their annual audit?_______________

7. How often do your clients change audit firms? Every 1-2 years?________
   Every 3-5 years?________
   More than 5 years?________

8. Within your C.P.A firm, is there a policy of rotating on a periodic basis the staff assistants on a given client's audit? Yes_______No________

9. If so, how often?______________

10. Is there a policy of rotating on a periodic basis the senior accountant on a given client's audit? Yes________No__________

11. If so, how often?

12. Is there a policy of rotating the manager in charge of a given client's audit? Yes___________No____________

13. If so, how often?________________________

14. Is there a policy of rotating the partner in charge of a given client's audit? Yes__________No____________

15. If so, how often?___________________

16. In light of the Metcalf Report and the proceedings of the Senate Subcommittee with regard to studying how to improve accounting and auditing, it is necessary for the accounting profession to take some measures toward self-regulation. With this in mind, do you feel that the future may hold a policy of compulsory rotation of C.P.A. firms among clients? Yes_______No_________

17. Do you feel that such a policy would increase an auditor's independence, which is a primary ethical consideration in the accounting profession? Yes____No_____

18. Do you feel that such a policy would cause an auditor to be more objective in his dealings with clients? Yes________ No________

19. How do you feel about a policy of rotating auditing firms among clients on a routine basis?

20. Please use the remainder of this page to make any further comments.

Return to: Mrs. Sarah C. Dawkins, Department of Accountancy, Room 200, College of Business Administration, Memphis State University, Memphis, Tennessee 38152

APPENDIX B

The Fortune 500

Appendix B contains a list of the largest United States industrial companies. The controller of each of these 500 companies received a questionnaire, an example of which is presented in Appendix A.

FORTUNE'S 500

Largest U. S. Industrial Corporations

ACF Industries, Inc.
A. E. Staley Mfg. Co.
AMAX, Inc.
AMF, Inc.
AMP, Inc.
A. O. Smith Corp.
A-T-O, Inc.
Abbott Laboratories
Addressograph Multigraph Corp.
Adolph Coors
Agway, Inc.
Air Products & Chemicals, Inc.
Airco, Inc.
Akzona, Inc.
Alco Standard Corp.
Allegheny Ludlum Industries
Allied Chemical Corp.
Allis-Chalmers Corp.
Alumax, Inc.
Aluminum Company of America
Amerada Hess Corp.
American Bakeries Co.
American Beef Packers
American Brands, Inc.
American Broadcasting Companies
American Can Co.
American Chain & Cable Corp.
American Cyanamid Co.
American Hoist & Derrick Co.
American Home Products Corp.
American Motors Corp.
American Petrofina Corp.
American Standard, Inc.
Amstar Corp.
Amsted Industries, Inc.
Amtel, Inc.
Anaconda Co.
Anchor Hocking Corp.
Anderson, Clayton & Co.
Anheuser-Busch, Inc.
Archer-Daniels-Midland Co.
Armco
Armstrong Cork Co.
Arvin Industries, Inc.
Asarco, Inc.
Ashland Oil, Inc.
Associated Milk Producers
Atlantic Richfield Co.
Avco Corp.
Avnet, Inc.
Avon Products, Inc.
B. F. Goodrich Co.
Babcock & Wiley Co., Inc.
Baker International Corp.
Ball Corp.
Bausch and Lomb, Inc.
Baxter Travenol Labs.
Beatrice Foods Co.
Becton, Dickinson & Co.
Belco Petroleum Corp.
Bell & Howell Co.
Bemis Co., Inc.
Bendix Corp.
Bethlehem Steel Corp.
Black & Decker Mfg. Corp.
Blue Bell, Inc.
Bluebird, Inc.
Boeing Co.
Boise Cascade Corp.
Borden, Inc.
Borg-Warner Corp.
Briggs & Stratton Corp.
Bristol-Myers Co.
Brockway Glass Co.
Brown Group, Inc.
Brunswick Corp.
Bucyrun-Erie Co.
Budd Co.
Burlington Industries, Inc.
Burroughs Corp.
CBS, Inc.
CF Industries, Inc.
CPC International
Cabot Corp.
Cameron Iron Works, Inc.
Campbell Soup Co.

Campbell Taggert, Inc.
Cannon Mills Co.
Carborundum Co.
Carnation Co.
Carrier Corp.
Castle & Cooke, Inc.
Caterpillar Tractor Co.
Celanese Corp.
Central Soya Co., Inc.
Cerro-Marmon Corp.
Cessna Aircraft Co.
Certain-teed Corp.
Champion International Corp.
Champion Spark Plug Co.
Charter Co.
Chemetron Corp.
Chesebrough-Ponds, Inc.
Chicago Bridge & Iron Co.
Chromalloy American Corp.
Chrysler Corp.
Cincinnati Milacron, Inc.
Cities Service Co.
Clark Equipment Co.
Clark Oil & Refining Corp.
Clorox Co.
Cluett, Peabody & Co., Inc.
Coca-Cola Co., Inc.
Colgate-Palmolive
Collins & Aikman Corp.
Colt Industries, Inc.
Columbia Pictures Industries
Combustion Engineering, Inc.
Commonwealth Oil Refining
Con-Agra, Inc.
Cone Mills Corp.
Congoleum Corp.
Consolidated Aluminum Corp.
Consolidated Foods Corp.
Container Corp. of America
Continental Group, Inc.
Continental Oil Co.
Control Data Corp.
Cook Industries, Inc.
Cooper Industries
Corning Glass Works, Inc.
Crane Co.
Crown Central Petroleum
Crown Cork & Seal Co., Inc.
Crown Zellerbach
Cummins Engine Co., Inc.
Curtiss-Wright Corp.
Cutler-Hammer, Inc.
Cyclops Corp.
Cyprus Mines Corp.
Dairylea Cooperative, Inc.
Dan River, Inc.
Dana Corp.
Dart Industries, Inc.
Dayco Corp.
Deere & Co.
Del Monte Corp.
Diamond International Corp.
Diamond Shamrock Corp.
Digital Equipment
Dover Corp.
Dow Chemical Co.
Dresser Industries, Inc.
E. I. duPont de Nemours & Co.
Eagle-Picher Industries, Inc.
Eastern Gas & Fuel Assoc.
Eastman Kodak Co.
Eaton Corp.
Economics Labs., Inc.
Eli Lilly & Co.
Eltra Corp.
Emerson Electric Co.
Emhart Corp.
Envirotech Corp.
Esmark, Inc.
Ethyl Corp.
Evans Products Co.
Ex-Cell-O Corp.
Exxon Corp.
FMC Corp.
Fairmont Foods Co.
Farmland Industries, Inc.
Federal Co.
Federal-Mogul Corp.
Federal Paper Board Co.
Ferro Corp.
Fieldcrest Mills, Inc.
Firestone Tire & Rubber Co.
Flavorland Industries, Inc.
Fleetwood Enterprises, Inc.
Flintkote Co.
Ford Motor Co.
Foster Wheeler Corp.
Foxboro Co.

Fruehauf Corp.
Fuqua Industries, Inc.
GAF Corp.
GATX Corp.
G. D. Searle & Co.
Gannett Co., Inc.
Gardner-Denver Co.
General Cable Corp.
General Dynamics Corp.
General Electric Co.
General Foods Corp.
General Host Corp.
General Instrument Corp.
General Mills, Inc.
General Motors Corp.
General Refractories Co.
General Signal Corp.
General Tire & Rubber Co.
Genesco, Inc.
George A. Hormel & Co.
Georgia-Pacific Corp.
Gerber Products Co.
Getty Oil Co.
Gillette Co.
Gold Kist, Inc.
Goodyear Tire & Rubber Co.
Gould, Inc.
Great Northern Nekoosa Corp.
Great Western United Corp.
Green Giant Co.
Greyhound Corp.
Grumman Corp.
Gulf & Western Industries, Inc.
Gulf Oil Corp.
H. H. Robertson Co.
H. J. Heinz Co.
H. P. Hood, Inc.
Hammermill Paper
Handy & Harman
Hanes Corp.
Hanna Mining Co.
Harnischfeger Corp.
Harris Corp.
Harsco Corp.
Hart Schaffner & Marx
Hercules, Inc.
Hershey Foods
Heublein, Inc.
Hewlett-Packard Co.
Hobart Corp.
Hoerner Waldorf Corp.
Honeywell, Inc.
Hoover Co.
Hughes Tool Co.
Hygrade Food Products Corp.
Hyster Co.
IC Industries, Inc.
I-T-E Imperial
Idle Wild Foods, Inc.
Indian Head, Inc.
Ingersoll-Rand Co.
Inland Container Corp.
Inland Steel Co.
Inmont Corp.
Insilco Corp.
Interco, Inc.
Interlake, Inc.
International Bus. Machines
International Harvester Co.
International Minerals & Chem.
International Multifoods Corp.
International Paper Co.
International Systems Controls
International Tele. & Tele.
Interstate Brands Corp.
Iowa Beef Processors, Inc.
J. P. Stevens & Co., Inc.
Jim Walter Corp.
Johns-Manville Corp.
Johnson & Johnson
Jonathan Logan, Inc.
Joseph E. Seagram & Sons
Joseph Schlitz Brewing Co.
Joy Manufacturing Co.
Kaiser Aluminum & Chem.
Kaiser Industries Corp.
Kane-Miller Corp.
Kayser-Roth
Kellogg Co.
Kellwood Co.
Kennecott Copper Corp.
Kerr-McGee Corp.
Kewanee Industries, Inc.
Keystone Consolidated Indus.
Kimberly-Clark Corp.
Knight-Ridder Newspapers, Inc.
Koehring Co.
Koppers Co., Inc.
Kraftco Corp.
LTV Corp.
Land O'Lakes, Inc.
Lear Siegler, Inc.
Lever Brothers Co.
Levi Strauss & Co.

Libby, McNeill & Libby
Libby-Owens-Ford Co.
Liggett & Myers
Litton Industries, Inc.
Lockheed Aircraft Corp.
Lone Star Industries, Inc.
Louisiana-Pacific Corp.
Lubrizol Corp.
Lykes-Youngstown Corp.
MAPCO, Inc.
MBPXL Corp.
MCA, Inc.
M. Lowenstein & Sons, Inc.
Macmillan, Inc.
Marathon Oil Co.
Martin Marietta Corp.
Masco Corp.
Mattel, Inc.
McConnel Douglas Corp.
McGraw-Edison Co.
McGraw-Hill, Inc.
McLouth Steel Corp.
Mead Corp.
Merck & Co., Inc.
Midland-Ross Corp.
Miles Labs., Inc.
Minnesota Mining & Mfg.
Mobil Oil Corp.
Mohasco
Monfort of Colorado, Inc.
Monsanto Co.
Morton-Norwich Products, Inc.
Motorola, Inc.
Murphy Oil Corp.
NCR Corp.
NL Industries, Inc.
NVF Co., Inc.
Nabisco, Inc.
Nalco Chemical Co.
Nashua Corp.
National Can Corp.
National Distillers & Chem.
National Gypsum Co.
National Service Industries
National Steel
Newmont Mining Corp.
New York Times Co.
Norris Industries, Inc.
North American Philips Corp.
Northrop Corp.
Northwest Industries, Inc.
Northwestern Steel & Wire
Norton Co.
Norton Simon, Inc.
Occidental Petroleum Co.
Ogden Corp.
Oil Shale Corp.
Olin Corp.
Oscar Mayer & Co., Inc.
Outboard Marine Corp.
Owens-Corning Fiberglas
Owens-Illinois, Inc.
PPG Industries, Inc.
Pabst Brewing Co.
Paccar, Inc.
Parker-Hannifen Corp.
Peabody Coal Co.
Peabody Galion Corp.
Peavey Co.
PepsiCo, Inc.
Pennwalt Corp.
Pennzoil Co.
Perkin-Elmer Corp.
Pet, Inc.
Pfizer, Inc.
Phelps Dodge Corp.
Philip Morris, Inc.
Phillips Petroleum Co.
Phillips-Van Heusen Corp.
Pillsbury Co.
Pitney-Bowes, Inc.
Pittston Co.
Polaroid Corp.
Potlatch Corp.
Proctor & Gamble Co.
Pullman, Inc.
Purex Corp.
Quaker Oats Co.
Questor Corp.
RCA Corp.
R. J. Reynolds Industries
R. R. Donnelley & Sons Co.
Ralston Purina Co.
Rath Packing Co.
Raytheon Co.
Reliance Electric Co.
Republic Steel Corp.
Revere Copper & Brass, Inc.
Revlon, Inc.
Reynolds Metals Co.
Rexnord, Inc.
Richardson-Merrell, Inc.

Rischhold Chemicals, Inc.
Riviana Foods, Inc.
Rockwell International Corp.
Rohm & Haas Co.
Rohr Industries, Inc.
Roper Corp.
SCM Corp.
St. Joe Minerals Corp.
St. Regis Paper Co.
Savannah Foods & Indus.
Saxon Industries, Inc.
Schering-Plough Corp.
Scott Paper Co.
Scoville Mfg. Co.
Seaboard Allied Milling Corp.
Shelber-Globe Corp.
Shell Oil Co.
Sherwin-Williams Co.
Signal Co., Inc.
Signode Corp.
Simmons Co.
Singer Co.
SmithKline Corp.
Southwest Forest Industries
Spencer Foods, Inc.
Sperry & Hutchinson Co.
Sperry Rand Corp.
Springs Mills, Inc.
Square D
Squibb Corp.
Standard Brands, Inc.
Standard Oil Co. of Calif.
Standard Oil Co. (Indiana)
Standard Oil Co. (Ohio)
Stanley Works
Stauffer Chemical Co.
Sterling Drug, Inc.
Stokeley-Van Camp, Inc.
Studebaker-Worthington, Inc.
SuCrest Corp.
Sun Co., Inc.
Sunbeam Corp.
Sundstrand Corp.
Superior Oil Co., Inc.
Sybron Corp.
TRW, Inc.
Talley Industries, Inc.
Tecumseh Products Co.
Tektronix, Inc.
Teledyne, Inc.
Tenneco, Inc.
Tesoro Petroleum Corp.
Texaco, Inc.
Texas Instruments, Inc.
Texasgulf, Inc.
Textron, Inc.
Thiokol Corp.
Thomas J. Lipton, Inc.
Time, Inc.
Times Mirror Co.
Timken Co.
Trane Co.
Trans Union Corp.
Twentieth Century Fox Film
USM Corp.
U. S. Gypsum Co.
U. S. Industries, Inc.
U. S. Steel Corp.
UV Industries, Inc.
Union Camp Corp.
Union Carbide Corp.
Union Oil Co. of Calif.
Uniroyal, Inc.
United Brands Co.
United Merchants & Mfgs.
United Refining Co.
United Technologies Corp.
Universal Leaf Tobacco Co.
Upjohn Co.
Utah International, Inc.
VF Corp.
Varian Association
Vulcan Materials Co.
W. R. Grace & Co.
Wallace-Murray Corp.
Walter Kidde & Co., Inc.
Ward Foods, Inc.
Warnaco, Inc.
Warner Communications, Inc.
Warner-Lambert Co.
Washington Post Co.
Wean United, Inc.
West Point-Pepperell, Inc.
Western Electric Co., Inc.
Westinghouse Electric Corp.
Westmoreland Coal Co.
Westvaco Corp.
Weyerhaeuser Co.
Wheelabrator-Frye, Inc.
Wheeling-Pittsburgh Steel
Whirlpool Corp.
White Consolidated Indus.

White Motor Corporation
Whittaker Corp.
Willamette Industries, Inc.
William Wrigley, Jr., Co.
Williams Companies
Witco Chemical Corp.
Xerox Corp.
Zenith Radio Corp.

VITA

Sarah Elisabeth Tourné Crais, the daughter of Mrs. Josette Tourné Crais, and the late Mr. Stewart Martin Crais, was born in New Orleans, Louisiana, on September 7, 1946. She received her elementary and secondary education in private and public schools in New Orleans, graduating from Benjamin Franklin in May 1964.

In September 1964, she entered Louisiana State University in Baton Rouge and received the Bachelor of Science degree with a major in accounting in May 1968. After working as an accountant during the summer of 1968 for Shell Oil Company in New Orleans, she entered Graduate School at Louisiana State University in Baton Rouge in the fall of 1968. While earning her Master's degree, she served as a graduate assistant in the Department of Accounting. During the summer of 1969, she worked as a trainee in a local public accounting firm in New Orleans. On September 6, 1969, she was married to Ronald Wayne Dawkins of Metairie, Louisiana. In August 1970, she received a Master's of Science degree with a major in accounting.

In the fall of 1970, she entered the Ph.D. program with a major in accounting and a minor in management. She served as a graduate assistant in the Department of

Accounting through the fall of 1971. On January 12, 1973, a son, Stewart Charles Dawkins, was born. On December 28, 1973, another son, Christopher David Tourné Dawkins, was born.

In August 1975, she accepted a faculty position as an assistant professor in the Department of Accountancy at Memphis State University in Memphis, Tennessee. She is currently a candidate for the degree of Doctor of Philosophy in the Department of Accounting.

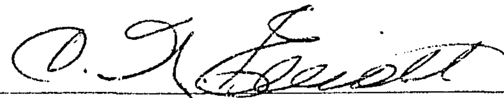
EXAMINATION AND THESIS REPORT

Candidate: Sarah Elisabeth Tourné Crais Dawkins

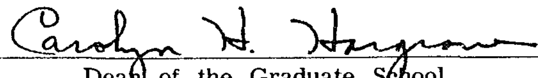
Major Field: Accounting

Title of Thesis: An Inquiry Concerning The Selection, Rotation, and Retention of Independent Auditors

Approved:

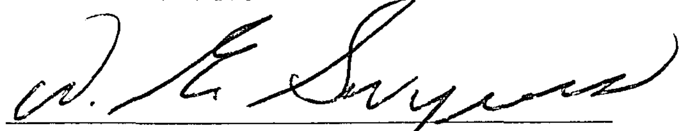


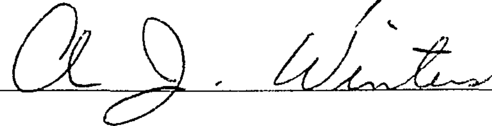
Major Professor and Chairman

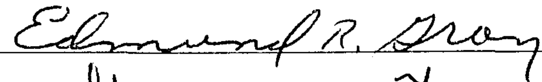


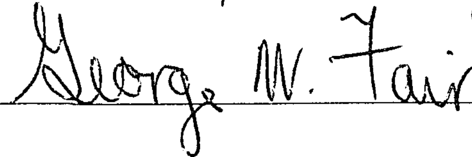
Dean of the Graduate School

EXAMINING COMMITTEE:









Date of Examination:

December 1, 1978