

## **Auditing: Objective Evidence vs. Subjective Judgments**

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**to**

**Foundation for Accounting Education  
New York State Society of CPAs**

**Tuesday, September 9, 2003**

**Metropolitan Hotel  
569 Lexington Avenue  
New York, NY 10022**

Today's financial statements of most companies are not auditable. How can I be so bold, and confident I might add, to say that today's financial statements are not auditable?

Well, let's look at the definition of some words. What does the word "audit" mean? The word "audit," according to my New Webster's World College Dictionary, Third Edition, means, among other things, "1. a formal, often periodic examination and checking of accounts or financial records to verify their correctness." I repeat, "to verify their correctness." What does the word "verify" mean? Again, according to Webster's, "verify" means "1. to prove to be true by demonstration, evidence, or testimony; confirm or substantiate; 2. to test or check the accuracy or correctness of, as by investigation, comparison with a standard, or reference to the facts." I repeat, "to prove to be true by [reference to] evidence" and "to...check the accuracy or correctness." Read those words to a lay person, and that person will say that amounts in audited financial statements should be accurate and correct and that evidence was obtained by the auditor to verify or check their correctness. It was clear in the Congressional hearings in the winter and spring of 2002, which followed Enron's implosion in December 2001, that members of Congress believe that amounts in audited financial statements included in filings with the Securities and Exchange Commission and sent to shareholders and employees should be accurate and correct. That's what the words "audit" and "verify" mean. But, that is not what auditors do.

Why don't we auditors do what those words say and mean? We auditors use the word "audit" a hundred times a day in our conversations. We use it in every audit report that we issue as a result of an "audit" of a client's financial statements, whether that client is a public company, a non-public company, a church, a museum, a school, a city or county or bridge or tunnel authority, or a charity. Those audit reports – approximately 15,000 of them - are filed with the Securities and Exchange Commission every year. Why don't we auditors do what the word "audit" means? What it means to every one but us auditors? It

is because we auditors have our own meaning of the word “audit.” It means what we auditors say it means in our own world. I will explain.

The balance sheets of most public companies show some amount of cash, which amount the auditor can verify the correctness of by reference to a bank statement and a confirmation from the bank. So, the amount of cash shown in the balance sheet can be verified objectively by the auditor by reference to a source outside the reporting enterprise. In other words, by reference to evidence. The balance sheets of many public companies show some amount of accounts or loans receivable. The amount of individual accounts or loans receivable can be verified objectively by the auditor by confirming the balance directly with the debtor. In other words, by reference to evidence. The balance sheets of some public companies show some amount for marketable securities held for sale or available for sale and carried at market prices. The market prices of those securities can be verified by the auditor by reference to financial publications or by confirmation with a broker. In other words, by reference to evidence. The balance sheets of many public companies show some amount of accounts or loans payable. The amount of individual accounts or loans payable can be verified objectively by the auditor by confirmation directly with the creditor. In other words, by reference to evidence.

Notice that I used the words objectively and evidence with respect to cash, accounts and loans receivable, marketable securities carried at market prices, and accounts and loans payable. The auditor can audit, or verify, the correctness of those amounts in the balance sheet objectively by reference to evidence obtained from persons outside the reporting enterprise. Bank statements, outside financial publications, and confirmations with or from third parties are evidence, objective evidence, about management’s representations in a balance sheet.

Let’s look at the meaning of the word “objective.” Again, according to Webster’s, the word “objective” means, among other things, “1. of or having to do with a known or perceived object as distinguished from something existing only in the mind...of the person thinking; 2. being, or regarded as being, independent of the mind; real, actual”. Thus, when I say that an amount in the balance sheet can be audited or verified objectively, I mean that the amount can be corroborated or determined by reference to something external to the mind of the person that determined the amount that is shown in the balance sheet. So, that takes care of cash, accounts and loans receivable, marketable securities carried at market prices, and accounts and loans payable.

The amounts for other items in the balance sheet of most public companies cannot be determined objectively. Cannot be audited. Cannot be verified. Why is that? It is because those amounts reside in and come from the mind of the person who put them in the balance sheet. Those amounts are determined subjectively.

What does the word “subjective” mean? It means, among other things, again according to Webster’s, “1. of, affected by, or produced by the mind or a particular state of mind, of or resulting from the feelings or temperament of the subject, or person thinking, not objective; personal; 2. determined by and emphasizing the ideas, thoughts, feelings, etc.

of the artist or writer...” The amounts for the other items in the balance sheet, that is, the amounts for other than cash, accounts and loans receivable, marketable securities carried at market prices, and accounts and loans payable, come from the mind of the person that determined those amounts. Those amounts generally are called “accounting estimates” in accounting parlance. Those amounts cannot be audited or verified by an auditor, the Securities and Exchange Commission, a bank or insurance regulator, or anyone else. Examples of those accounting estimates are shown as an appendix to Statement on Auditing Standards No. 57, “Auditing Accounting Estimates,” issued by the Auditing Standards Board of the American Institute of CPAs. (See AU Section 342) Examples are allowances for credit losses, whether a decline in the value of securities available for sale or held for the long term is other than temporary, useful lives and residual values of plant and equipment, recoverability of plant and equipment cost, probability of high correlation of a hedge, realization of deferred tax assets, impairment of goodwill, loss reserves of casualty insurers, and computed liabilities of life insurers with respect to whole life and similar policies.

What are accounting estimates? Accounting estimates are management’s judgments, assumptions, predictions, and speculations about unknowable future events. Which accounts or loans receivable will not be collected? Which assets will have to be sold for an amount of proceeds less than carrying amount? For how long will plant and equipment be used to generate revenue and positive margins? When plant and equipment is sold, what will be the sales price (residual value)? Will there be sufficient taxable income in the future to absorb operating loss carryforwards when the tax effect of the carryforward has been recognized as an asset? Let me quote from paragraph .03 of AU 342:

**Management is responsible for making the accounting estimates included in the financial statements. Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management’s judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.**

In other words, accounting estimates are management’s ideas about unknowable future events. Those ideas can be nothing but subjective.

Moreover, in most financial statements, the amounts of accounting estimates, and the effects of those accounting estimates on the financial statements, are material.

What is the audit standard that the auditor employs when auditing management’s accounting estimates? The audit standard for auditing accounting estimates is as follows, and I quote from paragraph .04 of AU 342:

**The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole.**

Now, how does the auditor determine whether the amount of an accounting estimate is “reasonable”? The auditor can do nothing more than apply his or her judgment to management’s judgment. What then do we have? We have judgments by the auditor piled on top of judgments by management!

I ask this audience, how many times, in your practice of public accountancy, have you written a working paper comment along the following lines regarding a client’s accounting estimate: “Appears reasonable”? How many times, in your practice of public accountancy, have you reviewed a working paper prepared by a subordinate where the subordinate wrote words along the following lines regarding a client’s accounting estimate, “Appears reasonable”? No doubt, hundreds, perhaps thousands of times. I know that I wrote and reviewed hundreds maybe thousands of such comments when I was doing audits.

Many commentators have said that it is appropriate for management to make judgments about accounting estimates. And that it is appropriate for the auditor to apply his or her judgment to those judgments made by management. That’s what got us where we are today. For example, that’s what got us to where we almost always see losses on the sale or abandonment of plants, but seldom gains, which means that depreciation expense was understated in years prior the sale or abandonment. That’s what got us to the situation today where there is overcapacity in the domestic and worldwide auto industry, but individual auto companies are not writing down plant and equipment costs. That’s what got us to the situation today where there is overcapacity in the domestic and worldwide commercial airline industry, but individual owners of the aircraft are not writing down the costs of the aircraft on their balance sheets. Overcapacity also exists in domestic copper wire telecoms, but we are seeing no write downs of plant costs. The use of judgment is what got us the savings and loan debacle in the 1980s. The use of judgment is what got us 1207 retroactive restatements of previously issued financial statements in the five years ended December 31, 2002 by public companies as reported by Huron Consulting Group. (See [www.huronconsultinggroup.com/resourcelibrary/restatementstudy2002](http://www.huronconsultinggroup.com/resourcelibrary/restatementstudy2002)) The use of judgment is what got us the Sarbanes-Oxley Act of 2002. The use of judgment is what got us the Public Company Accounting Oversight Board.

Why is it that we auditors must apply our judgment to a management judgment? It is because the Financial Accounting Standards Board and the International Accounting Standards Board issue standards that allow and require management to use its judgment in determining amounts in balance sheets. This audience knows well about the dozens and dozens of places in the FASB’s standards and other utterances such as FASB Interpretations and hundreds of consensuses issued by the FASB’s Emerging Issues Task Force, and several dozen Audit and Accounting Guides that were vetted by the FASB

prior to their issuance by the AICPA, where the literature that corporate managers and their auditors must follow call for the application of judgment.

Well, what should we do? Many have called for the auditor to determine “substance over form” and determine the reporting enterprise’s “true economic financial condition.” After Enron’s implosion, Congress held many hearings about what it should do to prevent future Enrons. In those hearings, which ran for days and weeks on C-SPAN, we heard members of Congress say that balance sheets should present corporations’ “true economic financial condition.” We now have the July 25, 2003 report by the staff of the Securities and Exchange Commission on principles-based or objectives-based accounting standards wherein the staff refers more than three dozen times to the “economic substance of transactions and events” and the “underlying economic reality of transactions and events.” (See the SEC’s Press Release 2003-86 announcing issuance of its staff’s “Study Pursuant to Section 108(d) of Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System” at [www.sec.gov](http://www.sec.gov)) That idea will not work unless we adopt a different accounting system. If, however, we keep today’s accounting system and if the standard is that the corporation must report transactions, events, and conditions according to their substance – so as to present the corporation’s true economic financial condition - and then the auditor must apply his or her judgment to the result, we will have anarchy in financial accounting and reporting; that is so because each chief executive officer, each chief financial officer, each audit committee, and each auditor will have his, her, or its idiosyncratic view of “substance over form” and “true economic financial condition” with the result that financial accounting and reporting will be all over the lot.

I don’t know what substance over form means. In paragraph 160 of its Concepts Statement 2, the FASB said, “Substance over form is ...a rather vague idea that defies precise definition.” I don’t know what reporting the substance of transactions means. I do know how to report corporations’ true financial condition. To do that, however, requires deep and fundamental reform to our financial reporting system. It requires marking to market corporations’ assets and liabilities – estimated, immediate selling price of non-cash assets and estimated, immediate settlement price of liabilities not yet due, which in turn requires separating the reporting responsibilities on corporations’ balance sheets between external auditors and external valuation experts.

To accomplish such reporting, managements first would have to develop their own estimates of selling prices of non-cash assets and settlement prices of liabilities not yet due. (Managements have a very good idea of those prices.) Then, corroboration of those prices would have to be obtained from sources external to the reporting enterprise – from valuation experts who are not related to or affiliated with the reporting enterprise. The reports of those valuation experts would be included in the quarterly and annual reports issued by corporations so that investors would know where the prices of the assets and liabilities came from and the qualifications of the experts that furnished the prices. The audit reports of auditors, reporting on the amounts for which they have and take responsibility, would be set forth separately from those of the valuation experts.

You may be quick to ask, Well, won't those selling prices of non-cash assets and settlement prices of liabilities not yet due be as subjective as managements' subjective judgments about "accounting estimates"? Won't those prices just be the managements' and the outside valuation experts' subjective opinions about what price (amount of cash) the assets would fetch if they were sold and what amount of cash would be necessary to settle a liability which is not yet due to be settled? Won't those prices just be speculations about future events? You are correct. Even for readily marketable assets, say 100 shares of General Electric, using the price of today's last transaction involving GE's shares on the New York Stock Exchange as an estimate of tomorrow's selling price of the 100 shares of GE stock is an estimate about a future event. But, those prices would not be masquerading as amounts certain as accounting estimates do in today's financial statements. Managements' estimates of those prices would be corroborated by external valuation experts. Moreover, those current prices would be relevant to investors and investors could understand and therefore judge those prices; investors have no way of judging today's "accounting estimates."

What would be the benefits of such a reporting system, one based on estimated selling and settlement prices, with separate reports by auditors and valuation experts? First off, and most importantly, it would produce financial statements that would be simple and understandable to investors, both retail and institutional investors, men and women in Congress, and ordinary people who walk up and down Main Street. Be understandable to directors of corporations. Corporate governance would take a quantum leap forward. Today's financial statements – full of accounting estimates and prepared following all of the FASB's rules – are incomprehensible except to those accountants that have memorized the FASB's rules. There are more than 330,000 members of the AICPA. I can tell you from experience – and I have been in this profession for more than 46 years – that there are not many of those 330,000 CPAs who understand all of the FASB's rules.

The second benefit would be that the responsibilities of the external auditor and external valuation expert would be set forth separately and clearly. The auditor's opinion on that which can be verified by an auditor would be separate from the valuation expert's opinion setting forth that expert's opinion on the market prices. That information that is subjectively determined would be clearly separated from that which is objectively determined. Auditors no longer would claim to audit that which is not auditable, as they do today.

Finally, there would be no more retroactive restatements of previously issued financial statements. That fact alone should help restore investors' confidence in financial statements. Couple that fact with the fact that investors would be informed, for the first time, of relevant current prices of assets and liabilities, and investors' faith in financial statements, which has plummeted since Enron and WorldCom, should begin to come back.

When I testified before the Senate Banking Committee in February 2002 in the hearings that followed Enron's implosion, I recommended that Congress require mark-to-market accounting. My recommendation was not adopted. Congress instead passed the

Sarbanes-Oxley Act of 2002. But Sarbanes-Oxley does not address the root problem. Yes, Sarbanes-Oxley requires improved auditor independence. Yes, Sarbanes-Oxley requires better corporate governance. Yes, Sarbanes-Oxley imposes prison terms on executive officers for cooking the books. Yes, Sarbanes-Oxley established the PCAOB. None of those measures, however, addresses the technical accounting and auditing issue that I have spoken about today, which is the root of the Enron problem.

The PCAOB cannot make a silk purse out of a sow's ear. The PCAOB can require that all audit firms register with the PCAOB. The PCAOB can send its staff to inspect the audit firms' audit procedures and their actual audit steps by inspecting audit files with respect to individual "audits" of financial statements filed with the SEC. The PCAOB can even try to write and issue better audit procedures or standards than did the AICPA's Auditing Standards Board. But, I cannot see how the PCAOB, and the audit firms that the PCAOB is and will be regulating and overseeing, can overcome the fundamental infirmity inherent in today's financial statements, to wit, the issuer of the financial statements determines, judgmentally and subjectively, many of the amounts, material amounts, in the issuer's financial statements, and then those amounts, which cannot be audited or verified, are said to be audited. Unless that infirmity is cured, those financial statements will continue to be unauditible, and we will have more Enrons. To me, the solution is obvious - the FASB and IASB should require mark-to-market accounting. And, the SEC should require separate reports by external auditors and external valuation experts in quarterly and annual reports to shareholders.

Would it cost more to prepare financial statements than it does nowadays if assets and liabilities were marked to market and issuers had to obtain separate reports from external auditors and external valuation experts? No doubt the answer to that question is yes. I estimate that the annual cost of audits today for 15,000 public companies is 8 – 10 billion dollars. Assume that amount would be doubled or even tripled to 20 - 30 billion dollars under mark-to-market accounting because of the need to involve outside valuation experts. If we compare the increase in fees of 10 – 20 billion dollars to the cost of an Enron or WorldCom, and the dozens of others of like kind just in the last five years, that increase in fees easily is absorbed just by the lost market capitalization of say 60 billion dollars by one Enron. By comparison to the total market capitalization of the US corporate stock and bond markets of more than 20 trillion dollars, the amount of 20 billion dollars would be a small price to pay. And, finally, when making a cost-benefit analysis, we need to look at the cost of lost investor confidence as a result of Enron, WorldCom, and dozens of others of like kind – 1207 of them in the last five years by the count of Huron Consulting Group; this cost is immeasurable but surely is huge. Would the benefit of mark-to-market accounting be greater than the cost? In my opinion, the answer to that question is yes.

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