Discussant's response to future extensions of audit services, meeting investors' future needs

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Future Extensions of Audit Services;
Meeting Investors' Future Needs

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Columbia University

Historically, when I have been asked to comment on the observations of a leading member of the public accounting profession I have been in the position of saying, "Go faster; look at the potential benefits of innovation rather than emphasizing the costs and dangers." After reading Don Bevis' paper, I am happy to be able to say "three cheers!" It may even be that some of my remarks might be interpreted as urging deliberate rather than precipitous speed toward some of his well articulated objectives.

Two Principal Extensions

The paper develops two principal extensions of the attest function: reporting on forecasts and reporting on management performance. I concur that both are logical and needed. It has long been my view that the current short form report which is the auditor's principal public output represents an enormous public underutilization of the competence of the highly talented professionals who perform audits. To render a standard report, substantial economic and human investments must be made which could logically lead to far greater and more useful public output than two standard paragraphs. This is not to belittle the importance of the attest function today, since I believe it is one of the underpinnings of our capital markets and corporate system, but simply to call attention to the opportunity costs which exist.

The paper devotes far more space to the subject of forecasting, and it develops the subject in an interesting and thoughtful manner. The discussion of auditing standards applied to forecast data and the illustration of possible audit reports on forecasts are significant contributions. They go far to indicate the conceptual feasibility of this extension of auditing within the broad framework of auditing standards today.

The second major extension discussed in the paper suggests an auditor's report on management performance, but the topic is only considered superficially. The author asserts his faith in the CPA's competence to undertake the task of evaluating management, and he incorporates by reference the article by Langenderfer and Robertson on the theoretical structure for such audits, but he does not offer any significant new insights of his own. While the fact that he supports such an extension of the auditor's function is in itself significant, one might have hoped for the same kind of new insights as to how this might be done as are found in the discussion on audits of forecasts.
Since I support fully the concepts advanced in this paper and because I largely applaud the way in which the author develops them, the rest of my comments will be devoted to some supplemental views on the topics advanced rather than specific comments relating to the paper.

Forecasts

The subject of forecasts has received great attention of late, both because of demands by investors and because of an apparent prospective change in the Securities and Exchange Commission's historical opposition to the public disclosure of forecasts in registration statements and other documents filed with the Commission. I concur with the conclusion in the paper that something is going to happen in the near future and it is important to make every effort to assure that it is the right thing.

The need for forecast data is a reflection of the fact that business is a continuum which cannot be adequately described by looking simply at history. Traditionally, history was valued for its objectivity and because it served as a basis for prediction. Recent developments have indicated that both of these qualities have perhaps been excessively attributed to financial statements to the detriment of users who accepted them on faith. Financial statements already contain many explicit forecasts, and in the face of the uncertainties of the future, it may be that our traditional single-valued format is obsolete. In addition, as Bevis points out, the world is now changing so rapidly that the predictive power of historical data is also being eroded.

An appropriate response to these developments is to expand the availability of future expectations which are being used by management to run the business, as well as possibly to adjust the traditional accounting model for "historical" financial statements. It is important, however, that in doing this, we do not create even in the short run a childlike faith on the part of users of financial statements in the forecasts which are presented. This means we must identify the uncertainties which exist and distinguish between history and projection both in forecast data and in standard financial statements.

A first step in this process would be clearly distinguishing in format between historical data and forecasts. I am troubled by Bevis' suggestion that for a stable business we could show "last year-this year-next year" data in simple columnar form. It would seem more desirable to make the "next year" data quite different in format. Perhaps we should use ranges or sensitivity analyses which analyze the relationships between data and identify the crucial variables which will affect the operations of the business in the future. It should not be the job of the Company or the auditor to furnish a simple crutch for the analyst such as next year's earnings per share. Rather, information about the business continuum—past, present and future—should be supplied in a variety of formats appropriate to the information being communicated so that improved allocation of resources in the economy can take place.

The public accountant's role in this process is twofold. First, he must be a reporting consultant who can effectively discuss with the company the types of disclosure which would be appropriate in particular circumstances. This will not simply represent the performance of a truth ritual; it will require long and
hard work to establish criteria for various kinds of data and then probably the application of personal judgment to many ad-hoc problems.

Second, the auditor must add reliability to the forecast data which is reported to the public. Here he must play the role of the objective, dispassionate professional. He must understand what represents good current forecasting techniques and decide whether they are in use in a particular firm. He must appraise assumptions. While he may today possess many of the skills necessary in this area, a significant increment will be required and must be developed within the profession if this function is to be performed.

There are several other problems in this extension of the audit function which must be considered and acted upon. The question of liability for error is a major one. In some fashion this must be defined. In addition, we must deal with the problems of self-fulfilling prophecies in forecasting. One of the major arguments against presenting next year’s income statement is that the fact of public presentation will bias the subsequent actual figures in the direction of the forecast. If the same auditor reports on both, the problem is made more acute, although both forecast and historical data are part of the information system under audit. With sufficient quality controls in the firm, a rotation of staff and other increases in professionalism, these problems may be overcome.

Evaluation of Management

The extension of the attest function to the evaluation of management is in some ways more frightening and in others more familiar than its extension in the forecast area. Auditors have appraised internal control for many years, even though few public reports have been issued thereon and few probably will be until SAP 49 is revised. Nevertheless, appraisal of a control system in the largest sense is a form of management appraisal. The review of the system does not complete the appraisal of management but it is a starting point.

Another step may be associated with the audit of forecasts. Management itself has long used the analysis of the variances that arise between actual and forecast data as a means of appraising subordinates, and the same general approach may be applied to the top management by an outsider such as an auditor or analyst. The CPA might, for example, express an opinion as to the fairness of a company’s description of the reasons for variances between historical and forecast data. This would leave the decision as to whether the variance was a management deficiency or a chance fluctuation up to the user of the statement.

It may well be that the evaluation of management will take the form of a number of specific attestations such as the ones relating to control and the explanation of variances just referred to. It seems unlikely that a single overall appraisal could be effectively presented until standards have been developed, and there are few signs that such development is imminent. A piecemeal approach therefore seems more likely. This is not inconsistent with the ideas expressed by Bevis, although he does not explicitly predict development in this fashion.

Summary

In the final analysis, I can only agree with and cheer for Don Bevis’ forecast as to the extension of the attest function, even if I cannot as a CPA ethically associate my name with it in a manner which may lead to the belief that I vouch for its achievability.