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The New AICPA Audit Commission—
Will the Real Questions Please Stand Up?

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The AICPA's Board of Directors has recently authorized the appointment of a Commission to make a full-scale study of the functions and responsibilities of independent auditors. It is my understanding that the Commission will consist of seven members, with four members coming from outside the CPA ranks and three from within. The Commission members are yet to be appointed, but I understand the chairman will be from outside the auditing profession. Basically, I believe the establishment of such a Commission is a very positive step that can lead to vast improvements in the world of auditing—IF. If the right issues are addressed and the right questions asked.

During the past fifteen years, as we all know, the auditing profession has come under severe attack. This is particularly true today with increasing pressures from the regulatory bodies, the courts, and society as a whole. The volume of suits filed against auditors has gone up dramatically in the past few years. Also, the grounds for these suits appear to be widening, as indicated by the fact that criminal indictments are being sought and returned against auditors. It seems as though every day is a new day with a different set of ground rules and the auditor is caught somewhere in the middle.

If this is true, then can the mere establishment of a Commission to study auditing be effective? In order to address that question, let us examine the Commission's potential charge as it might be gleaned from the questions contained in the March 11, 1974 issue of The CPA:

1. What responsibility should an auditor have for detecting fraud?
2. Should auditors monitor all financial information released to the public and, if so, what should be the extent of their responsibilities?
3. Should the auditor’s standard report, particularly the phrase “presents fairly,” be changed to express better the responsibilities of auditors?
4. What mechanisms should be adopted to strengthen the functions of auditors?
5. Is the mechanism for developing auditing standards adequate?
6. What should the profession do to reduce the risks of misunderstanding about its role?

In reading these questions, I get the feeling we are continuing to take the same old approach that we have in the past. The questions appear to be addressed primarily to segments of our activities and do not deal with the broader
issues of auditing. Unless the Commission interprets its charge broadly in light of recent and anticipated changes in our society and our economy, I hold little hope for its success. What are these so called broad fundamental issues?

Some Premises

Certain assumptions defining the environment of auditing are necessary in order to properly address ourselves to the issues.

Auditing Exists in a Dynamic Environment. Almost every aspect of the audit is subject to change. At one end of the spectrum, information processing technology has given rise to new auditing techniques. At the other end, society's values are changing—our performance and utility are measured by a constantly changing yardstick.

Information Technology. One of the most noticeable areas of change relates to information processing technology. Changes implemented by clients have necessitated adaptation of many traditional auditing tools. This same technology has permitted the profession to introduce more sophisticated and more effective tools.

The processing activities being carried out by clients have changed. Communications and terminal technology have led to extensive remote access to machine-sensible data. This, in turn, has had some tendency to reduce the volume of documents that are available for verification. Still further, the development of integrated systems with operations research models imbedded into the normal flow of data processing has resulted in having transactions initiated and then processed within the same computer system. Without dwelling excessively on this point, it suffices to say that it has been necessary to adapt auditing procedures to meet the changing situation.

In a very real sense, the auditing firm is a business that must itself take advantage of changing technology to improve both the cost and effectiveness of its operations; it has been necessary to use computers to apply tools such as statistical sampling and model building that are needed to meet our professional obligations.

Some of the advances in the information processing area have the potential for making subtle, but significant changes in auditing objectives. The development and implementation of large-scale data bases has raised increasing concern regarding security and privacy issues. Will the auditor, who is already charged with an objective review of a company's data processing system, eventually be held responsible for attesting to the performance of controls in this area?

As another possibility, assume that a company's financial statements are disseminated by having investors use remote terminals to access reports maintained in the data bank of an information utility. Will this movement have an impact on the auditor's liability exposure by altering the definition of the foreseeable class of users? Will the flexible retrieval capabilities of such systems force the auditor to offer the equivalent of piecemeal reports, since users can access any parts of the statements that are relevant to their decisions? Will the auditor's opinion have to be broadened to encompass interim reports, since reports maintained on such a system will certainly be updated during the year?

Social Attitudes. In the same sense that it was possible to say that the
changes in information processing technology are altering the operating envi­

ronment, it is equally clear that there have been changes in social attitudes. 

Directly and indirectly, more attention is being focused on managerial actions. 

Will (should?) we eventually take a position regarding the effect of manage­

ment’s actions on resource allocation, on the utilization of energy resources, or on 

minority groups as a potential source of employees?

Changes in social attitudes are particularly important for the auditing 

profession. The scope of our liability is ill-defined. In this age of consumerism, 

it is all too common for limits to be imposed after the fact by courts that are 

reacting to legal actions. This point is of crucial importance. Rule 23 of the 

Federal Rules of Civil Procedure makes it easy to institute class actions. The 

class actions, in turn, increase the magnitude of our exposure and tend sometimes 

to shift the focus of interest away from the party allegedly wronged and to the 

plaintiff’s attorney as the individual who has the largest readily identifiable 

financial interest in the action.

In summary, then, the auditor is operating within an ever-changing environ­

ment—one that is creating both new opportunities and new pressures.

Utility Is in the Eyes of the Beholder

There is no rationale for auditing services unless they serve some definable 

objective. In a market-oriented economy, this means that the absence of such 

utility will certainly result in an unwillingness to incur the cost of the services. 

In the quasi-regulated position of auditing, the lack of utility results in either 

a reluctance to mandate the performance of services or the establishment of addi­

tional regulatory pressures to align the services provided with the identified 

needs.

The most important observation following from this premise is that the 

auditor has only limited control over the nature of the attest function. Utility 

is determined, not by the auditor, but by the market for his services. This is a 

complicated situation, because the attitudes of the market place are constantly 

changing. Not only are the values changing, but the use of the regulatory 

agencies and courts to force further changes and realign economic distributions 

compounds the problem.

A System Is Needed to Link the Auditor to His Varied Audience

Operating within the environment specified above, it is clear that commu­

nication between the auditor and his audience should not be left to after­

the-fact determinations by the courts and the regulatory agencies. The current 

situation leaves something to be desired.

An argument can be made that the profession is talking to itself when we 

talk about not having any responsibility for detecting fraud. The same is true 

with regard to our attempts to define the class of intended financial statement 

users as being either informed or naive (or both simultaneously).

Leaving the resolution of these issues solely to the regulatory bodies may 

not be useful. In the past, regulatory attempts have often proven to be hap­

hazard efforts to resolve short-run issues. For example, the SEC has recently 

the profession must rest upon.
issued a pronouncement requiring the disclosure of inventory profits. While well intended, the requirement fails to give adequate recognition to the broader issues associated with reporting the effects of price level changes. Regulatory agency rulings rarely reflect the kind of unified, internally consistent, perspective that

In summary, then, the auditing environment can be characterized by:

1. A need to operate in a constantly changing environment.
2. A utility structure that is influenced by its audience.
3. A need for communication between the auditor and the market for his services.

General Parameters of a Useful Framework

It is necessary to examine the framework of auditing before we can make sensible recommendations regarding crucial issues influencing the profession. There should be general agreement that the major product of the auditing profession is attestation, i.e., offering a professional opinion regarding actions taken by others.

Attestation. Systems theory tells us that the effective functioning of a system requires that each of its elements must function in accordance with predetermined performance standards. Also, each element must have available information on the conditions existing in any other elements on which it depends, i.e., there must be reliable communication.

Attestation enters into this process in two ways. First, it is a convenient tool for use in a very large system where it is not possible for each element to individually verify the functioning of the elements upon which it depends. In this context, it can be argued that to justify reliance, it is more efficient for an independent attester to review various elements and offer judgments regarding their functioning, than to have each element verify each other element’s performance. And second, one should not overlook the behavioral impact of attestation on a system that has a goal and knows that its actions are being examined. This is the well documented behavioral impact of auditing—the fact that people will alter their behavior because they know that they are being watched.

Attestation is thus a two-pronged tool for controlling a system. It provides information regarding the activities that are taking place in a given segment of the system. At the same time, it alters the actions of some system elements in order to keep them aligned with a set of assumed goals.

Parties of Benefit. If you are willing to grant the framework presented above, then it becomes clear that we can get our feet back on the ground and identify two specific groups that can and do benefit from our attestation services:

1. Users of Information. This class includes credit grantors, investors and regulatory agencies. In a less direct sense, it includes the voting populace, who by their electoral capabilities, can influence the regulatory environment. The class also includes decision makers in a large organization who are located a distance away and therefore unable to conduct their own verifications.

2. Managers. Reference is being made here to the behavioral impact of the attestation process. The class of managers is potentially very
large. The owners of large corporations are certainly included, since they use this process as one of several tools for keeping management aligned with stockholder objectives. The regulatory agencies fall into this same broad category. And finally, the management of the business uses this same approach on a much smaller scale.

Attestation and the Auditor

If one is to make sense out of the current situation, one must take the statements regarding attestation in general and relate them to the current situation. There are several questions of critical importance. What is the relationship between the profession and the various governmental agencies? What is the scope of the profession?

Governmental Relationship. A very careful balancing act must take place in terms of the relationship between the auditing firm and the governmental agency. The agency mandating auditing services should certainly be one that is influential, i.e., one that can associate serious penalties with failure to satisfy existing standards. At the same time, the requirement for attestation services must be framed in a manner that does not take away flexibility in meeting the needs of the market place. There is, of course, a middle ground that attempts to balance the needs of the regulatory agency with those of the auditing profession and society.

Identification of the auditing profession with a particular governmental agency is a two-edged sword. For historical reasons, the profession has become identified with financial representations. This, in turn, led to its association with the SEC. While the power of the SEC gives the profession much of the power that it currently has, it also creates problems. There is the constant threat of the SEC “take-over.” There is also an identification with the financial community that makes it hard for us to address other attestation-related needs to society.

Scope. There is conceptually no limit to the scope of attestation activities. At the same time very practical limits do exist. As a practical matter, the value of the attestation services must be validated in the market place by the willingness of society to pay for the services. Hence, there is a definite need to recognize two factors—the expertise that is actually possessed by the attestor and the extent to which society is willing to grant him this expertise.

The close relationship with societal attitudes is at the heart of many of our problems. Auditing has been traditionally associated with financial representations. Firms in the field have thus sought to employ staff members who have a financial orientation, just as these financially trained people have sought out the firms. Financial identification is further reinforced by the involvement of the profession with the SEC. There is thus a definite limit to the profession’s ability to define its own scope (at least in the short run). This point is the basis for some of our present difficulties. On the one hand, society sometimes attributes expertise to us, even if we deny that we possess it. This is the case with regard to the detection of fraud. On the other hand, it limits our ability to alter the scope of practice, since the value of the services provided depends on both the expertise that we actually possess and on the expertise that society is willing to grant us.
Toward a Dynamic Future

The present situation is far from satisfactory. As members of a recognized profession, we cannot sit back with any real degree of self-satisfaction.

There is a definite need for two types of research and development activities on an on-going basis. It goes without saying that there must be a continual up-grading of current services. Hence, there must be research to maintain the status quo in the face of changing technology and to improve the things we are now doing.

It is absolutely essential that there be an on-going program looking into new areas of attestation. There are two reasons for this need. First, like any business, the auditing firm must be able to adapt to changing needs and to introduce new services for which there is a demand. The fact that the value of auditors' services is at least partially determined by society is a point that cannot be overlooked. If there is no research to develop skills with which we can be identified, it is highly unlikely that society will give us credit for these skills (and what's more, dangerous if they do give us such credit).

It may sound heretical, but as a practical matter, the profession does and should pay attention to the marketing of its services. Classical lore has it that the market beats a path to the better mousetrap, but that is not a safe enough base upon which to build the profession. It is necessary to give explicit attention to the development of a well organized marketing mechanism for the profession that not only makes the market aware of our expertise, but also of the limits associated with our services.

The Real Questions

In my preceding remarks emphasis has been placed on financial representations, because this has been the traditional area of our expertise. Our legitimacy has been derived from both the market place and the securities laws, and this has further acted to define the nature of our image in the eyes of our audiences.

However, the current situation is quite critical. Legal suits are mounting together with the magnitude of the damages being claimed. Respected publications are questioning the way in which we are handling our affairs. There is reason to believe that auditing lacks respectability within the academic institutions—our primary education and research arm. How many schools would offer auditing courses in the absence of the CPA exam and state licensing requirements? How many doctoral students are looking to auditing as an area for specialization and research?

Commissions are appointed infrequently, with an expectation that they will have a significant impact. Hence, due care should be addressed to the charge of such a group. Appropriate objectives of this Commission should be to identify the issues facing the profession, the options available, alternative courses of action, and a structure for achieving an orderly resolution of the issues.

The questions that should be addressed should focus on the fundamental issues that are impacting the profession at the present, and those that have the potential for impact in the future. Among those issues are:

1. What is the role of the auditor in society? Our environment is formed by our expertise, by the legal structure surrounding our
actions, and by the attitudes of those who (potentially) use our services. To whom are we responsible? What are the attitudes towards the profession? What are our perceived strengths and weaknesses? What factors do our audiences focus upon when forming their opinions of us?

2. To what extent do we have the ability to influence our role in the future? As stated above, this role depends upon both our expertise and audience perception of our expertise. The apparent gap between our self-image and the users' views of us is at the heart of many of our current problems. Is it possible for us to establish a structure that will help to keep this image discrepancy within some acceptable bounds? How can we do this?

3. Who are the users of our services? The present structure assumes that particular users of our services (the relatively sophisticated creditors and investors) are dominant. This assumption is the basis of some present difficulties. Consideration must also be given to potential investors and creditors, as well as to management and the general public.

4. What are the decision making needs of the users? The Trueblood Committee studied the objectives of financial statements, and the committee findings are now being considered by the Financial Accounting Standards Board. Other user-related questions include the need to attest to forecasts and related underlying assumptions, adequacy of internal control, and management effectiveness.

5. What should the structure be to control quality and auditing standards? To what extent can the profession operate in a self-contained manner? Who should establish auditing standards? Who should monitor auditing quality? How can auditing be kept current, or will we need another Commission in a few years?

6. Should there be changes in the relationship between the auditor and the firm being audited? At the present time, the auditing firm is retained by a firm in order to offer an opinion regarding its financial representations. The auditing firm is presumably independent. It also presumably has a large degree of influence on the choice between alternative techniques. However, there are many who question this independence. There is no easy solution to the problem. While I am not proposing this solution, it is useful to recognize that in England, once the firm has chosen an auditor, it is very difficult for it to make a change. The system appears to work.

These are not all of the questions requiring answers and there may be some debate regarding the inclusion of one or two. Nevertheless, I believe they do focus on the fundamental issues that face the profession.

This is a most unique moment in the history of our profession. We have asked “outsiders” to help us identify the problems and develop solutions. We should view this Commission as an opportunity to objectively study our entire role and responsibility to society. Let’s all hope that the real questions—and answers—eventually stand up.