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**AUDITING OF PUBLIC  
PROGRAMS AS VIEWED BY  
THE PUBLIC ACCOUNTING  
PROFESSION**

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**AUDITING OF PUBLIC PROGRAMS AS VIEWED  
BY THE PUBLIC ACCOUNTING PROFESSION**

A President of the United States once made this profound observation: "Power and strict accountability for its use are the essential constituents of good government."<sup>1</sup> This meaningful statement strikes a vital chord with all citizens concerned with responsible government. It should also be of deep and significant interest to each of us here today, whose day to day tasks and responsibilities are focused almost wholly upon the determination of stewardship and accountability of governmental officials in a great variety of capacities and functions. Indeed, the governmental legislative or internal auditor and the independent certified public accountant engaged to perform auditing services in the governmental field comprise almost the exclusive group on which the broad public depends for a continuing determination of "strict accountability."

**TRENDS IN GOVERNMENTAL SPENDING**

The importance of accountability in government has taken on new dimensions in recent years with the highly accelerated growth in public spending at all levels of government. One third of this Nation's gross national product is now comprised of spending in the total public sector. Thus, the inroads upon our basic system of free enterprise have been swift and massive in recent years; even more alarming is the prospect that this trend will accelerate, not slow down. Consider these statistics:

- **Federal Spending** The Federal budget, under its present mode of accounting, showed total outlays in 1960 of \$92.2 billion. By fiscal 1968, total outlays

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<sup>1</sup> Woodrow Wilson, *Congressional Government* (New York : Meridian Books, 1956), p. 187.

had risen to \$178.8 billion, or an increase of 94% in eight years.<sup>2</sup> According to the unofficial figures for fiscal 1971, total outlays had vaulted to \$211.6 billion, or an increase of 130% in eleven years.<sup>3</sup> The Vietnam war and inflation are no doubt the principal causes of this increase, but expansion of domestic programs is far from an insignificant item in the total picture.

- **State and Local Government Spending** Total expenditures for operation of all state and local governments in the United States in 1960 aggregated about \$61 billion. By fiscal 1968, this figure had risen to \$116.2 billion,<sup>4</sup> an increase of 90%.

The comparative expenditures for State governments alone were \$31.6 billion in 1960 and \$66.3 by 1968,<sup>5</sup> or an increase of 110%.

Thus we find that of the levels of governments measured for the eight-year span, 1960 to 1968, state governments alone showed the most marked increase in spending by quite a margin.

- **A Note of Alarm** One interesting but alarming prognostication about where all of this rapid growth in government might lead us showed up in a recent article in the *Journal of Accountancy* by Leonard Savoie, Executive Vice-President of the American Institute of Certified Public Accountants. Mr. Savoie quoted from an in-house publication of a New York bank, as follows:

In the April issue of its house publication, the Morgan Guaranty bank in New York carried a tongue-in-cheek article which reached the conclusion that by the year 2049 everyone working for wages or salaries in the United States will be employed by the government.

To arrive at this prediction, the publication used a calculation worked out by that whimsical Englishman, Professor C. Northcote Parkinson, and applied to his own country.

The bank noted that in 1960 the U.S. civilian labor force numbered 69.6 million. In 1970 the labor force had reached 82.7 million – thus showing an increase of 1.75 per cent annually. Meanwhile, during the same decade, government employment in the U.S., counting all levels of government but not including the armed services, grew from 8.4 million to 12.6 million – a rise of 4.2 per cent annually.

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<sup>2</sup> *Statistical Abstract of the United States, 1970, Table No. 564.*

<sup>3</sup> *U. S. Bureau of the Budget, press release, July 28, 1971.*

<sup>4</sup> *Statistical Abstract of the United States, 1970, Table No. 612.*

<sup>5</sup> *Ibid., Table No. 619.*

Extrapolating these rates of increase on a chart, one finds that the two lines of growth cross in the year 2049, thereby demonstrating that, by that point in time, every member of the civilian labor force will be absorbed by government!

Needless to say, the bank concedes that this is a bit of 'statistical drollery.' But it does serve to highlight . . . the immense growth of government.<sup>6</sup>

## IMPACT ON THE AUDIT FUNCTION

As should be expected, the expansion of interest in stewardship and accountability has paralleled the unprecedented growth in government expenditures and directly led to a marked and rapid expansion of the audit function, both at the internal audit level and by independent public accounting firms.

- **Audits of Federal Programs** There are more independent audits made of Federal and State departments or agencies and of units of local government today than ever before. At the Federal level alone, largely because of the grants-in-aid programs, there are now approximately 51,000 audits of financial statements performed annually by CPAs under 80 programs being carried out by about 30 Federal agencies. Even more important is the reliance placed upon audits by independent public accountants of business concerns, such as SEC filings and audits of banks, savings and loan associations, public utilities, etc.
- **Trends in Auditing of States and Local Governments** While states and local governments have participated heavily in the expansion of the audit function, the predominant portion of that growth has been absorbed through enlarging and strengthening internal audit staffs rather than through the use of independent public accounting firms. Strangely enough, this has been more true of the states as a group than of the municipalities and other political subdivisions of the states. As of this date, there is still a very limited number of states that currently use outside auditors in examining the financial operations of their departments and agencies.
- **Audits of Local Governmental Units** A recent survey indicates that 33 states require audits of cities, towns and counties; seven states specify that the audit will be made by the state auditor. Of the remainder, the laws generally

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<sup>6</sup>Journal of Accountancy, July 1971, p. 68.

specify public accountants or the state auditor. But even in this category the use of CPA firms is not as widespread as might be expected.

- **Audits of State Agencies** It is my understanding that all states require audits of agencies and departments, although some of them may be performed biennially. However, nearly all of these audits are performed by State audit staffs. As indicated above, only a handful of states make broad and regular use of independent CPA firms in their audits of state departments and agencies.
- **Where the State Post Audit Function is Centered** It is of interest to note where the post audit function is centered in our state governments. In our 50 states, this is allocated by the various state statutes as follows:

Source of Control	Number
Legislative Auditor (or legislatively controlled) . . . . .	31
Elected State Auditors . . . . .	14
Appointed by Governor. . . . .	3
Appointed by Boards or Budget Bureau . . . . .	<u>2</u>
Total	<u>50<sup>7</sup></u>

Only a decade ago, there were far fewer states that had legislative auditors, reflecting a marked shifting of the primary post audit responsibility away from elected auditors and those appointed by the governor to an auditor appointed by and responsible to the state legislature.

Perhaps this marked trend is quite logical as many authorities and students of this subject build a strong case for controlling the state audit function at the legislative level. One author makes these observations.

Moreover, it is the thesis of this presentation that a properly conceived and effectively established legislative post-audit function is essential to the survival of an effective legislative control system and a meaningful balance of power between the legislative and executive branches of state government. The larger the State is and the more complex or extensive its programs are, the more critical such an audit function becomes.<sup>8</sup>

## POTENTIAL ROLE OF PUBLIC ACCOUNTING IN AUDITS OF STATE AGENCIES

It is clear from what has been said before that the role of the CPA firms to date has been a limited one in the audit of state agencies. Nonetheless, the examples of such experience, however, limited, can be characterized as highly successful. In these conference sessions today we have heard two highly complimentary and detailed reports on such experience in the states of Colorado and Illinois. Had these excellent speakers not preceded me on the program, I am sure I would have devoted a significant portion of my own presentation to the successful programs being followed in these two states, as striking evidence of the value and quality of service, at comparable cost, that states can expect from the public accounting profession in the audit of state agencies.

It would seem inevitable that the use of CPA firms would expand in the conduct of financial audits of state agencies. It is my understanding that the states of Rhode Island and Arizona make substantial use of CPA firms for this purpose and my own state of Utah has in recent years used outside auditors for audits of the Liquor Commission, the State Treasurer's office, and the State University. Requests for funds for added independent audits have been made to but not granted by the State legislature over the years.

- **Reasons Legislative Auditors Should Make Wider Use of Independent CPA Firms** There are a variety of reasons why legislative auditors of the various states should consider wider use of independent CPA firms in the conduct of their audit programs. The more significant of these reasons would include the following:

1. The state audit staffs would receive the benefit of the broader experience and expertise of independent CPA firms whose staffs generally have:

Greater numbers of certified public accountants.

More intensive training.

A broader base of experience in industry, nonprofit organizations

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<sup>7</sup> *Council of State Governments Survey, 1969; Commonwealth of Massachusetts Legislative Research Bureau Report, February 17, 1971.*

<sup>8</sup> *Lennis M. Knighton, "The Case for a Legislative Post Auditor," State Government, Autumn, 1969.*

generally and, in some cases, the field of government.

More extensive programs for review of the system of internal control in each state or agency.

More technically advanced audit programs and procedures.

Knowledge of specialized audit techniques, such as full training and experience in use of statistical sampling, auditing through computers, etc.

Greater depth and experience in preparation of audit working papers.

The knowledge of time-saving audit techniques, producing added efficiency in the preparation of audit working papers.

2. Use of independent auditing firms offers the special advantage of providing joint audit experience for members of state audit staffs by participation on appropriate engagements under the supervision of the CPA firm. The range of joint participation should include all field work, workpaper reviews, report preparation, and guidance in preparation of comment letters and their review.

In addition, most public accounting firms would gladly offer to conduct, at no added cost to the state, staff training sessions for the state audit group.

3. Where only partial use of CPA firms is made, their representatives would normally be available on special assignment to review audit programs on agencies developed by state staff members, to help improve their technical quality and efficiency, often to a measurable degree. Likewise, the CPA firm would be available to review work papers and reports on agency audits assigned to state staff members and submit constructive comments thereon.

A further area of partial assistance in such circumstances would be, on agencies being examined for the first time, to assist in writing audit programs in order to make such audits as effective as possible.

The value of such consultation and cooperative assistance to state audit staffs can be highly significant.

4. Use of outside auditing firms provides additional credence as to the independence of those performing the audit engagement. It is well known that independence is the cornerstone of the public accounting profession. Thus, not only is the factor of independence present but the appearance of independence is more fully evident to the legislature, the executive branch and to the general public.

## NON-FINANCIAL AUDITS AT ALL LEVELS OF GOVERNMENT

One of the very significant challenges before the accounting profession in the United States today is to delineate clearly the role of the CPA in the performance of audits other than the traditional examination of financial statements. One of the paramount problems is to determine to what extent generally accepted auditing standards, as developed for guidance of CPAs in conducting financial audits, apply to compliance and performance or operational audits. To the extent such standards do not apply, then new standards must be developed.

It is going to be in the field of government, particularly at the Federal level, rather than industry where this effort will be spearheaded. The very basic need of Congress to determine that Federal grants to states and local governments are properly spent, with economy and effectiveness, and that the basic goals of the grants are being achieved requires that these types of audits be performed. Therefore, it is urgent that these standards be established as early as possible.

About eighteen months ago an Audit Standards Work Group (ASWG) was formulated from several departments and agencies within the Federal Government to develop auditing standards for the conduct of compliance and performance audits in the public sector. It is particularly significant that early in 1971, the American Institute of Certified Public Accountants officially joined hands with the ASWG in this vital project. While the program's primary purpose has been to improve the quality of auditing of federal assistance grants, I am sure that all CPAs and persons identified with government at all levels throughout the country can look forward to the ultimate publication of a highly useful and workable set of auditing standards that will apply broadly to the entire public sector. Likewise, these standards should be of special interest to internal auditors who now serve on state audit staffs or in other capacities within the public sector.

A second draft of the report of the Audit Standards Work Group was completed within the last month, which should advance the joint project several significant steps toward the goal of establishing workable audit standards for compliance and performance audits.

- **Financial Audits** One of the initial questions to be raised concerns the basic competency and qualifications of members of the accounting profession generally to perform these three classes of audits. As to the first of these,



financial audits, certainly the profession sees no problem; the auditing standards are fully established and the members of the profession nationwide hold themselves out to be competent and qualified to conduct examinations of financial statements of business enterprises and other organizations.

- **Compliance Audits** As to the compliance audits, no actual auditing standards have been established to date. However, a policy statement was adopted by the Council of the American Institute of Certified Public Accountants several years ago, in which it was noted there was “a rapidly-growing buildup in compliance work, often as an adjunct to audits. . . .” Noting that compliance requirements are often motivated by statute, the committee (on auditing procedures) pointed out that criteria applied to compliance work may differ very fundamentally from those involved in auditing. With this in mind, the committee reaffirmed its position that compliance work should be encouraged, as long as the accountant’s area of responsibility is clearly defined, and where the accountant’s skills equip him for the task. The committee suggested that this area receive increasingly extensive coverage in American Institute publications.

Thus, it was made clear that standards must be developed for this specialized and growing field.

In an exposure draft, circulated in February 1971 by the Institute’s Committee on Auditing for Federal Agencies, of a position paper outlining suggested guidelines for the structure and content of audit guides prepared by federal agencies for use by certified public accountants, it was pointed out that such audit guides should clearly establish at least two basic points with respect to compliance reporting:

1. Compliance audit work is a proper function of the independent auditor provided that his responsibility is clearly defined and his skill (i.e., his education and experience as an auditor) equips him for the task, and
2. Whether the compliance work is to be pursued only as an incident to the financial audit or whether the financial audit procedures are to be extended to cover some specific compliance matters.<sup>9</sup>

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<sup>9</sup> *Exposure draft of a position paper on “Suggested Guidelines for the Structure and content of Audit Guides Prepared by Federal Agencies for Use by Certified Public Accountants” by AICPA Committee on Auditing for Federal Agencies.*

This same position paper points out that:

It will be difficult at best to distinguish clearly *all* compliance items as between financial compliance and program compliance. Some matters are clearly one or the other, while others may not be easily classified. . . . It does not seem feasible that a general audit guide can include a comprehensive list of compliance items suitable for all grants or contracts. Some rather comprehensive but nonetheless broad instructions, however, are appropriate to establish the framework in which the auditor can and is expected to function.

In those cases where the auditor's effort in determining compliance is incidental to and a by-product of those audit procedures primarily concerned with determining the fairness of financial reports, his responsibility is limited to disclosing those aspects of non-compliance which are ascertained in the performance of such procedures.

On the other hand, where the auditor's engagement specifically identifies the effort to be expended for the direct purpose of examining compliance with various requirements, then his responsibility is such as to require the performance of adequate work so as to permit him to report with regard to those aspects of compliance so examined.<sup>10</sup>

- **Reporting on Compliance Audits** The position paper of the AICPA Committee sets forth some specific recommendations on reporting requirements:

Depending upon the type of program, the type of organization, and other factors such as audit of the grantee or contractor by other auditors, the Federal agency preparing the audit guide should specify its reporting requirements in these areas, recognizing that situations may vary from those in which the grant or contract involved is relatively minor in terms of the total activity of the grantee (e.g., a university) to situations in which the grant or contract is the total activity. . . .

If specific reporting is required on a grant or contract, it should be understood that extended audit procedures related thereto are required. When the grant or contract agreement requires separate reports in these areas, the CPA's report should describe the procedures followed, the findings resulting from tests and, if appropriate, suggested improvements.

Certain of the specific program compliance matters can be reported on based upon extended audit procedures. It is believed essential that the review of compliance with program requirements which necessitates examination beyond that typically identified with the audit of financial records and related audit procedures should

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<sup>10</sup> *Ibid.*

be separately identified in the preparation of audit guides by Federal agencies and should be reported upon in a separate section of the audit report.<sup>11</sup>

- **Performance Audits** Some members of the accounting profession question whether the function of performance auditing truly belongs in auditing or in the general area of management services such as those now being performed by certified public accountants.

This basic question may be answered in part, at least, by applying the same criteria as we did earlier with respect to compliance audits; that is, performance audit work is a proper function of the independent auditor provided that his responsibility is clearly defined and that his skill equips him for the task.

It seems clear that independent auditors can render such services if they relate to isolated assignments, such as the review of a purchasing department in a given organization within the public sector. To audit the over-all performance of an entire organization, however, in order to measure its efficiency, economy, and effectiveness poses, at the present time, genuine problems for the accounting profession as a whole.

One problem is that no complete set of standards for such types of audits have been developed to date. However, at least a beginning has been made. It is my understanding that the Committee on Management Services of the American Institute of CPAs is now working on the development of a set of standards for management services engagements. It is too early to predict what format they will take or when they will be available. In the meantime it is worth noting that this same Committee in February 1969 issued its Statement No. 2, one of a series of statements, entitled "Competence in Management Advisory Services." Among other items, the Statement sets forth these conclusions:

The CPA certificate is the accepted minimum evidence of high-level competence in the public accounting profession. The profession is, and has been for many years, identified as expert in management advisory services as well as accounting, auditing and tax matters. Beyond that, in the field of auditing, the profession has further stated certain general standards for the guidance of practitioners in *Statements on Auditing Procedure No. 33*.

The Committee on Management Services believes that general standards analogous to those adopted for auditing are applicable to management advisory services. These are listed as follows:

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<sup>11</sup> *Ibid.*

1. Management advisory services are to be performed by persons having adequate training and experience in both the application of the analytical approach and process, and in the subject matter under consideration.
2. In all matters relating to a management advisory services assignment, an independence in mental attitude is to be maintained by the member and his staff.
3. Due professional care is to be exercised in the performance of management advisory services.<sup>1 2</sup>

It will be quickly noted that these three standards of competence are adaptations of the three general standards set forth for the guidance of independent auditors in Statements on Auditing Procedure No. 33. This leads us to the conclusion that whether performance audits are conducted by certified public accountants functioning in the capacity of independent auditors or in the area of management advisory services, these general standards, as heretofore promulgated by the American Institute of Certified Public Accountants (or the adaptations prescribed by the Institute's Committee on Management Services) may be said to apply.

It may be further stated that, in a general sense, the standards of field work, except No. 2 relating to review of internal control, would apply to performance auditing. The standards of reporting, of course, would not apply and new ones will have to be fully developed.

A second problem is generally recognized within the accounting profession and among many officials in organizations within the public sector. The problem is: As a prelude to development of performance auditing standards and before contemplating such audits on a substantial scale, broad programs to improve the quality of financial management within the organizations should be undertaken. This is similar in principle to advising a potential financial audit client whose system of internal control is extremely weak to delay the audit until internal control is materially strengthened and its general procedures tightened.

Concurrent with such programs to improve internal financial management, considerable experience in performance-type auditing could be obtained by internal audit staffs within the organizations themselves. It is fairly widely known that much of this has been done at the federal level by the General Accounting Office, the Atomic Energy Commission, the Department of Health, Education and Welfare, and perhaps a number of other federal

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<sup>1 2</sup> Statement on Management Advisory Services, No. 2, *February 1969*, pp. 17-19.

agencies. Certainly some of it has been accomplished by internal audit staffs within the offices of state auditors and comptrollers. Perhaps the most conspicuous example shows up in the State of New York where the State Comptroller's office has been a leader in shifting emphasis in the direction of performance auditing. The first effort of that office started in 1964 and appears since to have made great strides toward achieving its objectives. Obviously, all of this experience should be capitalized upon to the fullest degree in the long-range effort to develop performance auditing standards. However, we must concede that the degree of independence achieved in the accounting profession as a whole is not likely to be matched by internal audit staffs in government.

Notwithstanding the extent of such experience, the position of the American Institute of Certified Public Accountants on performance auditing at the moment appears to be to set some long-range goals for developing auditing procedures for measuring efficiency and effectiveness, upon the basis of which guidelines and standards can then be developed. It is recognized that empirical research and a considerable body of experience are needed. At the moment, as a foundation for determining sound auditing standards, it is questionable whether the total reservoir of experience within the independent auditor segment of the accounting profession is adequate as a base for the immediate development of performance auditing standards, if they are expected to be of the quality and effectiveness of the generally accepted auditing standards developed in earlier years to govern the conduct of financial audits.

It is my understanding that either the American Institute of Certified Public Accountants or some of the larger accounting firms have expressed a willingness to conduct pilot studies within selected governmental organizations involving varied disciplines and to serve as a coordinator for their efforts, in order to evaluate such disciplines for efficiency and effectiveness. For example, statistical samples could be taken of many federal grants under a broad program in various areas throughout the country for the purpose of testing the economy, efficiency, and effectiveness of the programs utilizing such grants. At this point it is my understanding that the accounting profession would be willing to serve as the focal point for such an effort, as it is evident further experience and research are needed before the related auditing standards can be formulated.

In summation, it seems clear that both groups, the governmental organizations and the public accounting profession, have much to gain by a

cooperative and concerted effort to develop workable auditing standards for both compliance and performance audits: the former to receive independent assurance that governmental resources are expended for their intended purposes and that social services and benefit programs attain their designed objectives; the latter to take advantage of a remarkable opportunity to expand the areas of its professional service and concurrently serve the public good in an unprecedented fashion. ●