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Summary of Views Presented at the June 2, 1975 Meeting of the Commission on Auditors' Responsibilities' by the Interregulatory Accounting Committee (Chief Accountants of Federal Agencies)

Commission on Auditors' Responsibilities

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AICPA-Comm. on Auditor's Resp.
— Interviews: Chief Accountants
of Federal Agencies. cop. 45

Summary of Views Presented at the
June 2, 1975 Meeting of the Commission
on Auditors' Responsibilities
by the Interregulatory Accounting Committee
(Chief Accountants of Federal Agencies)

Those present at the meeting were:

<u>Name</u>	<u>Agency</u>
John Grady (Chairman)	ICC
Bryan Brown (Secretary)	ICC
Clarence Sampson	SEC
Sheldon Chazin	REA
Glenn Weinhoff	CAB
Alternate to Wayne Foren	SBA
Andrew Weissler	FMC
Robert Moore	Renegotiation Board
Arthur Schoenhaut	CASB (Exec. Sec'y.)
Lorin Drennan	FPC
William Mason	Export-Import Bank
William White	FCC

A. Auditors' Responsibilities Regarding Fraud (Issue IV) and Adverse Management Behavior (Issue VII) as Affected by Auditors' Relationships with Management (Issue XI)

The view was expressed that elements common to both management fraud and illegal corporate contributions are the subversion of the internal control system by management and the question of management's integrity and responsibility.

1. Disclosure of Adverse Management Behavior: Once such behavior is detected, to whom should the auditor go with this information? Especially when the accounting is prescribed as in the case of regulated companies, the question of the auditor's responsibility is one of to whom he should report. There is also the question of with whom within the company the auditor should deal. Will top management necessarily have the public responsibilities of the company at heart? There is the possibility that the existence of an audit committee made up of outside directors to oversee the auditor's responsibility would give the auditor greater independence in fulfilling his responsibility for disclosure. Disclosure of illegal acts such as political contributions is necessary, in either the financial statements or otherwise, since the acts often have effects beyond the financial statements.
2. Detection of Fraud and Adverse Management Behavior: The auditor has a clear responsibility to detect both fraud and adverse management behavior (particularly when federal laws are involved), despite the failure of current auditing

standards to convey this responsibility clearly. This responsibility cannot be put on management, since the issue is one of management fraud and management's adverse behavior. The auditor's responsibility for detecting adverse management behavior should be the same as that for detecting fraud, and the same concept of materiality should apply in each case. The SEC expects detection of adverse behavior only when a "red flag" exists and the auditor would have to close his eyes not to detect it.

The auditor should change his basic assumption that management has the best interests of the company at heart. Because internal controls are designed to prevent illegalities only at lower levels of management, the auditor must further evaluate the interests of upper level management in the company. The profession's image has been tarnished by the recent disclosures of illegal activities. Standards are needed here.

3. Cost/Benefit Relationships re Detection: In evaluating the benefits from an assumption by the auditor of responsibility to detect adverse management behavior, it should be recognized that actions involving amounts that are immaterial to the financial statements could have very material consequences, extending even to the viability of the company.

There are benefits to the company from an increased responsibility on the part of the auditor. The auditor's assistance to the process of federal regulation will make that process easier, and this would be beneficial to the company.

The cost of assuming responsibility for detection is reduced by several factors:

- a. Some items are discoverable in the normal course of an audit.
- b. To some extent, detection will result merely from the auditor's sensitivity and alertness to the problem.
- c. Only one or two areas could be looked into in a given year.
- d. New audit techniques could be developed, such as operational or management audits.

B. The Auditor as Advocate

The case was cited where an auditor assumed an advocate role on behalf of a client in a rate case without giving notice to that effect. In the case cited, the auditor disclaimed an opinion because of scope limitations, but did give negative assurances. It was alleged that both the data presented and the negative assurances were misleading because no indication was given that the auditor was not acting independently but as an advocate.

The suggested solution was that the auditor expand his report to delineate the work actually performed and specify his advocate role. The former is necessary because users interpret negative assurances as implying more than is intended; the latter is necessary because in the particular situation the advocate role was not clearly evident.

C. Substandard Performance

Concern was expressed by the chief accountant of the Rural Electrification Administration over the substantial number of cases involving substandard performance by auditors of electric cooperatives. Specific deficiencies cited were:

1. lack of familiarity with the uniform system of accounts
2. inadequate or unintelligible footnotes
3. failure to understand or report upon related party transactions
4. inadequate application of audit procedures, indicating that the auditors were "matching their work to the green"
5. scope of audit not related to adequacy of internal control
6. failure of work papers to indicate procedures employed
7. lack of narrative of work performed
8. lack of analysis of balance sheet accounts
9. failure to test transactions
10. lack of review of profit and loss accounts
11. failure of auditors to keep up to date regarding new developments in accounting and auditing.

REA does work paper reviews of firms that audit cooperatives. Copies of the REA reports were given to the Institute's Washington office, but there was no follow-through. REA can recommend a firm's entering into the AICPA quality review program. They have the power to force a change in auditors, but have not yet exercised that power.

D. Disclosure of Uncertainties

The issue was raised of the auditor's responsibility in situations where a company with government contracts has significant cost overruns or claims against the government. It was felt that the auditor has not fulfilled his responsibility to report on the bona fides of the claims that have been booked, even though settlement usually results in a return of 25 cents on the dollar to the corporation. (It was pointed out that auditors do have the responsibility at present under both GAAS and GAAP to evaluate these assets.) It was suggested that subsequent financial statements report on the settlement of claims reported in the previous year.

E. Cooperation between the Profession and the Government Agencies

1. Work papers of independent auditors should be shared with the agencies to avoid a duplication of effort.
2. There should be greater cooperation between the AICPA and the agencies.
3. There is a need for a mandatory peer review program.

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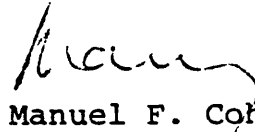
September 17, 1975

Mr. Douglas Carmichael
American Institute of CPA's
1211 Avenue of the Americas
New York, New York 10036

Dear Doug:

The attachment was sent to me by the
Federal Audit Executive Council. I believe it should
be distributed.

Sincerely,



Manuel F. Cohen

MFC:rp

enclosure (1) "Major Issues Concerning
Auditor's Responsibility"

MAJOR ISSUES CONCERNING
AUDITOR'S RESPONSIBILITIES

Responses Displayed
By Major Issue

Highlights

Issues generating the most comment .

- IV. The responsibility of the auditor for detecting fraud. (Page 7).
 - Set more guidelines
 - Review internal control safeguards
 - Require auditors to be constantly alert
 - Rely on normal audit procedures
 - Report indications to appropriate third parties

- VI. The possibility of extending the auditor's role in reporting on new forms of information, such as interim information (including the audit of record concept), and in reporting on other activities and characteristics, such as the efficiency of operations or the adequacy of internal control systems. (Page 14).
 - Expand audit scope
 - compliance
 - internal control
 - economy and efficiency
 - program results (effectiveness)
 - performance forecasts

- IX. The effectiveness of auditing methods and techniques and possibilities for improving effectiveness. (Page 23).
 - Train auditors more widely and thoroughly
 - Expand use of computers
 - Foster internal auditing
 - Encourage closer working ties between internal auditors and outside auditors

XIV. The effectiveness of the present process for establishing and administering procedures for recognizing individuals as qualified to practice as independent auditors, including the educational process, and possibilities for improving that process. (Page 30).

- Remove inconsistencies in requirements
- Obtain acceptance of Government auditing experience
- Improve academic curricula

I. The role of the independent auditor in the American society.

Defense

"As a general response, it is our view that the auditing profession in our society is looked to as an independent, qualified body responsible for reviewing, evaluating and reporting the results of a company's operations. In our experience, however, we believe that the profession has too narrowly interpreted this responsibility in emphasizing those aspects which impact directly on data reflected in financial statements. Recognizing the need to extend auditors' responsibilities under Government programs, the Comptroller General, in 1972, promulgated a body of standards which, when appropriate, requires an evaluation of economy, efficiency and achievement of desired results from operations, in addition to compliance and financial auditing procedures. In our view, these standards would also have some degree of applicability in the Public Accounting Sector. "

Government Printing Office

"The role of the independent auditor should be to assure stockholders and creditors that Management has performed as well or as poorly as indicated by the financial statements and that all relevant information has been included in the formal statements. Also, the independent auditor should report on weak internal controls to Management and/or Board of Directors. He should identify potential trouble spots but under no circumstances should he attempt to develop detailed procedures to strengthen weak controls. "

Treasury - Revenue Sharing (Mr. Beuley)

"I believe the independent auditor plays a vital role in the American economy. In a sense, the auditor protects the stockholder or consumer by providing an objective view of the financial situation of the various organizations which control the jobs and furnish the goods and services making up the American economy.

"There are many groups and organizations that protect the consumer from many types of problems. The independent auditors are the only group concerned with protecting the stockholders from misinformation on financial matters. "

Internal Revenue Service

"The AICPA should take positive action to build public confidence in the independence of auditors. The role of the auditor should be explained in layman's terms through the news media. Auditors must be made aware that they must be independent, objective and truthful in determining whether financial statements reflect the results of business operations in order to maintain a high degree of public confidence in their work."

II. The gap between the performance of independent auditors and the needs and expectations of users of audited financial statements.

Internal Revenue Service

"Identify the needs and expectations of the users of audited financial statements through interviews, questionnaires, etc. in order to formulate any changes to auditing standards, methodology, etc. Strengthen communications between the user and the independent auditor to assure that information on the financial statements is complete, accurate and understandable and information serves the real needs of all users. "

Labor

"Generally financial statements and/or audit reports fail to provide the desired information concerning the purpose for which the organization was established and the procedures followed to account for these functions. While auditors certify that the report 'presents fairly in accordance with generally accepted accounting principles' may be a true statement, such statements do not reflect the effectiveness with which accountability has been established. "

Treasury - Revenue Sharing (Mr. Beuley)

"One possible problem is a communications gap. The average investor does not know or really care about accounting terminology. I think some more 'down-to-earth' explanations of what the financial statements mean would close this gap. "

III. The auditor's responsibility in judging the "fair presentation" of financial statements and the role of "generally accepted accounting principles" in that judgment process.

Internal Revenue Service

"More clearly and concisely define these terms. Periodically reevaluate to determine relevance. "

Labor

"Generally financial statements and/or audit reports fail to provide the desired information concerning the purpose for which the organization was established and the procedures followed to account for these functions. While auditors certify that the report 'presents fairly in accordance with generally accepted accounting principles' may be a true statement, such statements do not reflect the effectiveness with which accountability has been established. "

IV. The responsibility of the auditor for detecting fraud.

DCAA

"...the primary responsibility for safeguarding a company's assets rests with management. Management should establish an adequate accounting system along with appropriate internal accounting controls. The financial statements are management's representations providing the financial position and the results of operations together with additional disclosures necessary for their proper interpretation.

"Since it is not feasible for an auditor to check all transactions in detail, reliance is placed on the internal control system for the prevention and detection of fraud. However, management must realize that a good internal control system is capable of being circumvented by collusion among employees or by collusion between employees and persons outside the company. When management directs the collusion to defeat the established internal controls the auditor is faced with an extremely difficult problem in determining how to detect the fraud, assuming that generally accepted auditing standards have been followed....

"In summary the AICPA position is that the ordinary examination is not primarily or specifically designed to detect defalcations or other irregularities. Auditor responsibility for detection of fraud arises only when failure to detect fraud clearly results from not complying with generally accepted auditing standards. The auditor relies on the adequacy of the accounting system and its internal controls to prevent and detect fraud.

"The Defense Contract Audit Manual (CAM) in setting forth our responsibility for the detection of fraud provides: 'Although the detection of fraud or similar unlawful activity is not a primary function of contract audit, the auditor must constantly be alert for situations or transactions that may be indicative of such activity....'

"Our audit guidance recognizes that the level of audit effort required to assure that all fraud or other unlawful activity is discovered would be prohibitive. However, throughout the CAM, references are made in the various audit programs for the auditor to be alert to the possibility of fraudulent activities. This alertness, combined with the operation of the contractor's internal controls and the auditor's normally programmed tests of procedures and transactions, should afford a practical and reasonable degree of assurance for disclosure of material fraud or other unlawful activity.

"The Auditing Standards Executive Committee of the AICPA has issued an Exposure Draft entitled, 'Proposed Statements on Auditing Standards: Related Party Transactions.' The statement provides audit procedures and steps to be followed to (i) determine the existence of related party transactions, (ii) identifying material transactions with related parties, (iii) examining related party transactions, and (iv) disclosure of related party transactions in the financial statements.

"One of the Big 8 CPA firms has issued a manual to their auditors to assist in detecting fraud....

"We concur in the conclusion of the AICPA Special Committee on Equity Funding that no significant changes in generally accepted auditing standards and procedures are necessary in the light of Equity Funding. We also must agree with the Committee that improvement in customary audit procedures is necessary to assure the probability of discovery of material frauds. The auditor has an obligation to discover material fraud when the proper application of customary auditing procedures will uncover the fraud. The role of the auditor is to be inventive, curious, and alert to any situation which may indicate an irregularity and devise those audit procedures which will resolve doubts."

Government Printing Office

"In light of recent events, creditors and stockholders are wary of fraudulent transactions which could result in the loss of their investments. In my opinion, the independent auditor should be able to detect inaccuracies in the financial accounts during the course of a normal audit. I do not think it is reasonable to expect the independent auditor to determine whether the incorrectness is due to unintentional errors or deliberate fraud. Also, his responsibility for finding fraud should be relative to the extent of the fraud. Massive fraud such as occurred with Equity Funding should have been uncovered by normal auditing procedures.

"The independent auditor should not be expected to function as an investigator during a routine financial audit. I believe the matter of determining who perpetrated the fraud and the amount of money involved is more appropriately handled by a team of trained investigators than accountants and auditors. This is not to say that accountants and auditors could not participate in the investigation; they should not have primary responsibility for conducting the investigation. Once the auditor has identified incorrect accounts, or

has a suspicion that the differences he detected could be due to other than clerical errors, he should report the circumstances to Management and the Board of Directors. If the discrepancies have not been satisfactorily resolved before presentation of the annual report, the auditor should qualify his opinion.

"The commission should also consider establishing a requirement that if the auditor suspects fraud he must inform an independent investigatory group, e. g. , Securities and Exchange Commission, FBI, etc. Such a requirement should not be used as an alibi so that every time a discrepancy appears, the auditor would refer it to the investigators; rather it is intended to provide some recourse to auditors who have reason to believe that the auditee is involved in some type of illegal activity. "

HEW

"Based on our review of the Statement on Auditing Standards (SAS) No. 1, Section 110.05 through 110.08--Detecting Fraud; the GAO Standards for Audit of Governmental Organizations, Programs, Activities and Functions; and our experiences in auditing federally assisted programs; we make the following comments....

"We suggest that SAS No. 1 (i) be revised to expand upon and incorporate a set of discovery guidelines for detecting fraud, and (ii) Section 110.07 should clarify 'proper representatives' with whom the independent auditor should confer when fraud or potential fraud is disclosed in an audit involving a third party with vested interest such as Federal and/or State funded projects, activities, or programs.

"Although the AICPA's tentative definition of fraud appears adequate, the term 'financial statements' as used therein should be expanded to specifically include final expenditure reports or required cost reports related to Federal grantee and contract audits. A more positive statement of the auditor's responsibility for detecting fraud in the examination of financial statements is needed. This responsibility should be expanded to cover more than just the ordinary examination of financial statements. An adequate set of internal controls will usually pick up any systematic falsification at the lower levels, but the hardest kind of fraud to detect is fraud committed by management. Moreover, a major concern in audits of grants and contracts awarded by the Federal Government is the acceptability of costs claimed. One

of the factors to be considered in determining the acceptability of these costs is the possibility of fraud in preparing the claim. This concern requires that the public accountant expand on methods of discovering fraud. . . . There are no audit procedures that will necessarily guarantee the discovery of all concealed management involvement, but auditors should not resign themselves to non-discovery. Therefore, perhaps, an AICPA sponsored set of discovery guidelines would assist auditors in this area.

"The 1972 GAO 'Standards for Audit of Governmental Organizations, Programs, Activities and Functions' (Yellow Book) addresses under two standards, the auditor's responsibility for dealing with possible fraud. The first one is the general standard for governmental auditing on DUE PROFESSIONAL CARE. . . . The second item is DISCLOSURE. As presented under the fourth reporting standard for governmental auditing disclosure should be based on weighted materiality. Although materiality is judgmental, six specific indicators are identified, including disclosure of characteristics of the items involved such as indications of malfeasance or misfeasance. During revision of the SAS, considerations of consistency with these standards is desirable.

"The specific issue of detecting fraud as contained in SAS No. 1, Section 110.07 provides in part:

' . . . if the independent auditor believes that fraud so material as to affect his opinion may have occurred, he should reach an understanding with proper representatives of the client as to whether the auditor or the client. . . is to make the investigation necessary to determine whether fraud has in fact occurred. . . . ' (Underscore supplied)

"Independent audits of federally funded projects, activities, or programs should give concern to the auditor as to the identification of the 'proper representative' with whom matters of possible fraud should be discussed. It is our view that where such audits are performed to meet requirements of Federal statutes, regulations, or administrative directives and particularly under an agreement incorporating the use of a Federal audit guide; the 'proper representative' should include the appropriate Federal officials. The proper contact points can be identified readily by reference to a Catalog of Federal Domestic Assistance and/or the applicable audit guide. We suggest that future Federal/AICPA coordinated audit guides, prepared for use by independent auditors, be more specific as to

channels of disclosure on fraud or possible fraud. This would be, basically, an interim provision pending modification to the applicable section(s) of the SAS.

"All reports on fraud or possible fraud should substantially meet the GAO 'Yellow Book' test on materiality. Such reports should be presented to Federal representatives for processing to the appropriate Federal investigative unit (and/or State investigative unit where State funds are involved). The investigative unit(s) will make the investigation necessary to determine whether fraud has in fact occurred. . . . Misuse of funds not involving criminal offenses should be handled, however, as an audit function.

"We note that Section 11 of the June 6, 1975 draft on the proposed SAS, Noncompliance with Laws and Regulations (reference No. 3620), provides guidance to the auditor regarding confidentiality of auditor-client relationship where concerned third parties are to receive notification. Where the Federal or State Government has a vested interest in the client's activities, or, in fact, the client is an agent under the grant or contract arrangement for either third party, the question of notification to the 'proper representative' (in terms of third parties) become paramount. We believe, therefore, that guidance should be given on disclosure of fraud or potential fraud to concerned third parties. "

IRS

"The auditor cannot guarantee against the existence of fraud but should be responsible for evaluating the adequacy of control systems designed to prevent or deter fraud and for making sufficient tests in those areas where fraud is most likely to exist. "

Labor

"Our engagements are primarily directed toward the expression of an opinion on the financial statements. Disclosure of fraud, defalcations and other irregularities may be discovered but this is not the purpose of the examination, rather discovery of deliberate misrepresentation by management is more closely associated to our audit objectives. "

Treasury - Revenue Sharing (Mr. Beuley)

"The auditor must always be alert to the possibility of fraud. Many of the standard audit steps will provide some indication of possible

problems. The auditor should pursue the questionable areas and report possible areas for further detailed investigation. "

Treasury - Revenue Sharing (Mr. Gary)

"The basic premise that the prevention and detection of fraud is primarily the responsibility of management, which is exercised by establishing an adequate system of internal control, is well established. However, this does not justify the position that some independent public accountants take that they have no responsibility for fraud detection. The same accountants who maintain this have rather detailed audit programs and internal control questionnaires many of the procedures of which relate specifically to the detection of fraud. It is admitted that the IPA* is not a guarantor in this respect any more than with regard to the fairness of presentation of the financial statements. Nevertheless, there appears to be a need to more clearly define precisely what the IPA's responsibility is with respect to fraud detection. The layman has a difficult time understanding just where the line should be drawn between a guarantor on the one hand and no responsibility on the other. "

*Independent Public Auditors (IPA)

- V. The auditor's role in evaluating the effect on financial statements, including the adequacy of disclosure, of uncertainties concerning the outcome of future events.

Government Printing Office

"I do not think auditors should be cast as fortune tellers. They are supposed to express opinions on historical data as to whether it is reasonably accurate and reliable. If a future event, e. g. , lawsuit, could have a material effect on the business, than that fact should be revealed to users of financial statements. The ultimate judgment concerning the outcome of future events should be made by the users of financial statements."

Internal Revenue Service

"If the auditor knows that some future event will have a significant impact on the financial position of the company he should disclose the full facts in his report. In case of doubt, report it."

- VI. The possibility of extending the auditor's role in reporting on new forms of information, such as interim information (including the auditor of record concept), and in reporting on other activities and characteristics, such as the efficiency of operations or the adequacy of internal control systems.

Air Force

"...Since the early 1960's, we have been in an era of management or operational auditing in which we appraise the total scope of an activity's operation.

"Management auditing consists of a comprehensive examination and constructive evaluation performed to assess the effectiveness and efficiency with which management plans, organizes, coordinates, directs, and controls resources to accomplish their mission. Under this concept, instead of examining only financial records, we look at factors such as the adequacy of organization structure, effectiveness of policies and procedures, reliability of controls, adequacy of protective methods, causes for variance, utilization of manpower and equipment, and efficiency of methods of operation. We do not stop with the identification of deficiencies or problem areas. We also determine the root cause of the problem and offer management suggested recommendations for improvement...."

Defense

"In our opinion, there is a need to extend the auditor's responsibility in this area. Two forms of information that we in the Department of Defense customarily evaluate and report on are company operating forecasts and the results of company operations, from the viewpoint of economy and efficiency of performance. It is recognized that a greater degree of judgment and risk is involved in evaluating the reporting on these forms of information; however, our experience demonstrates that auditors can perform meaningful evaluations in these areas."

DCAA

"The interests of users of reports on governmental audits are broader than the interests of users of reports concerning the credibility of financial statements. Since Government procurement officials are interested in getting the best product at the most reasonable cost,

our audits have always been directed toward determining the adequacy of contractor's financial forecasts, efficiency, and economy of operations and adequacy of internal control systems....

"Another area of major concern to DCAA is evaluation of contractor forecasts for contract performance, including budgetary controls.

"The AICPA Accounting Standards Division has issued an Exposure Draft on guidelines to be followed in issuing financial forecasts. The proposed guidelines include the following recommendations:

- a. Forecasts should be presented in the format of the historical financial statements. Typically, a forecast balance sheet, statement of income, and statement of changes in financial position.
- b. Quarterly forecast presentations supplementing annual forecasts may be presented in less detail.
- c. Forecast information should be presented as specific monetary amounts representing the single most probable forecasted result.
- d. Whenever a financial forecast requires a material change, the change should be disclosed by revising, updating, or withdrawing the forecast.

"Two other divisions within the AICPA are working on related aspects of financial forecasts. The Management Advisory Services Division is developing guidelines for systems for preparing forecasts, and the Auditing Standards Division is studying the role of a CPA's involvement with a client's forecasts....

"We in DCAA believe that there is a definite need for standards for preparation of financial forecasts and we strongly endorse all efforts in this regard. A major portion of our audit effort is the review of defense contractor price proposals for the performance of work over several future accounting periods. If the standards proposed in the exposure draft are followed by defense contractors in the preparation of their price proposals, it is our opinion that more effective defense contract pricing and costing will result. "

Government Printing Office

"I believe the independent auditor should express an opinion on the adequacy of internal controls because of their effect on the credibility of financial data. The scope of the audit should be directly proportional to the adequacy of internal controls. There should always be a minimum amount of audit work performed even when internal control is adequate. When internal controls are weak, the auditor should perform more extensive tests."

HEW

"With regard to Federal grantees and contractors, the nature of performance required by independent auditors is specified in the letter of engagement. Most often the requirement is for an audit, as opposed to a review or consultation. The auditor's involvement is expected to incorporate and utilize to the fullest extent available evidence-gathering methods.

"Federal/AICPA coordinated audit guides, prepared for use by independent auditors, should provide for an expanded scope of audit to incorporate not only financial and compliance auditing but also auditing for economy, efficiency, and achievement of desired results (effectiveness) where feasible and desirable.

"The need for extending the auditor's role in reporting on non-traditional activities and characteristics, and particularly as it relates to independent auditing firms, has been the topic of many discussions in recent months. Since adoption of the GAO 'Yellow Book' standards by issuance of Federal Management Circular FMC 73-2, the need to expand the scope of audit to incorporate the 3E's has been more apparent. The objectives in audit of Federal operations and programs, including grantees and contractors, should be designed to produce a full-scope audit where feasible and desirable.

"The new ethics ruling, made available June 1975, states the AICPA's position on use of audit guides issued by Governmental agencies. The independent auditor's responsibility under an agreement to perform audit services which incorporates a requirement to follow the Federal agency's audit guide was clarified. This ruling provides a basis for achieving expanded or full-scope audits of grantees and contractors. In the course of revising existing audit guides and preparing new guides, Federal agencies should place greater emphasis on expanding the scope of audit.

"Reporting requirements for the audits discussed above are normally provided in the audit guide. As a part of the terms of the agreement, distribution of the audit reports is made to the Federal grantee or contractor and the responsible Federal funding agency. These deficiency type reports should provide recommendations for financial settlement and program improvement. Once issued, such reports are available to the public under provisions of the Freedom of Information Act. "

IRS

"Interim information should be provided to selected individuals such as potential creditors, officers, Board of Directors and possibly to regulatory agencies as the need arises. Information regarding efficiency of operations or the adequacy of internal control systems would be informative and useful information and should be accordingly reported. The auditor's report should clearly spell out the scope of his engagement. If his role is extended into such areas as the efficiency of operations and the adequacy of controls, the auditor must be properly qualified to handle such engagements (e. g. , full understanding of principles and standards for conducting and reporting upon operational audits). Otherwise, he must not accept such engagements. "

Justice

"Within the Department of Justice, the Law Enforcement Assistance Administration (LEAA) is the predominate recipient of audit reports prepared by independent auditors. LEAA has had considerable dealings with public accounting firms who have performed independent audits of LEAA sponsored programs, particularly at the state and local government levels.

"LEAA's major concern has been the limited scope of the audits performed by public accounting firms. Based on LEAA's experience, audits performed by public accountants are generally restricted to a review of the auditee's financial operations, with little or no work done in reviewing (a) compliance with applicable laws and regulations, (b) efficiency and economy of operations, and (c) effectiveness in achieving program results.

"The interests of most users of audit reports of LEAA sponsored activities are broader than those that can be satisfied by audits performed to establish the credibility of financial reports. In order to provide information that will satisfy these broader interests, audits of a wider scope must be performed. . . .

"It is our view that the role and responsibility of independent auditors must be such as to guarantee audits of government sponsored activities that adequately satisfy the needs of the users of the reports and properly disclose the areas in need of improvement, whether it be a financial weakness or a failure to comply with applicable Federal and State laws and guidelines. Federal and State auditors, by virtue of their more intimate knowledge of the operations of State and local governments and of the goals and objectives of the programs being carried out, should be primarily responsible for determining efficiency, economy, and effectiveness.

"To assist independent auditors in providing the necessary financial and compliance coverage of Federally sponsored programs, we believe that Federal agencies should develop audit guides which clearly set forth the minimum work required by the sponsoring agency. These audit guides must be written in such a way as to clearly define the objective of each of the audit steps and provide sufficient data, including criteria, so as to permit a thorough understanding by the auditor, irrespective of the auditor's knowledge of the program being audited."

Labor

"Because interest may be both historic as well as prospective, information concerning a forecast of present or future operations is generally not provided."

Treasury - Revenue Sharing (Mr. Beuley)

"I think the auditor's role can be extended in the area of adequacy of internal control systems, but the areas of efficiency of operations should be done as a part of the management services reviews, not a regular audit."

Treasury - Revenue Sharing (Mr. Gary)

"The second standard of field work is: 'There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.'

"In view of the above, the reluctance of IPA's to accept engagements which include the reporting on internal control and the many qualifications which the AICPA requires to accompany such reports

(which makes extremely dull reading) seem quite ridiculous. What the profession is saying is that it can determine the adequacy of internal control for their own purposes but not for the benefit of their client. This position, I believe would be different and much more sensible if it was not for the constant fear by the profession of being sued. "

VII. The responsibility of the auditor for detecting adverse management behavior and for disclosing known adverse behavior to interested parties.

Air Force

"... Our basic philosophy is to report audit results to the lowest management level that can take corrective action, while at the same time keeping higher organizational levels that have a management interest in the audit subject matter area advised of conditions. In addition, whenever instances of irregular conduct or violation of public trust are detected, we immediately notify officials at the secretariat level of the Air Force...."

Defense

"Interpreting adverse management behavior as that which results in uneconomical or inefficient performance, vis-a-vis behavior of a fraudulent nature, we would see a need to extend auditors' responsibilities in line with comments under Issue VI. More particularly, auditors' responsibilities should be extended to include an evaluation of such management activities as policy formulation, decisionmaking processes and performance evaluation techniques. As in the detection of fraud in connection with an audit of financial transactions, a normal evaluation of operations should not be expected to discover deliberate misrepresentation by management leading to inefficient or uneconomical operations."

HEW

"A proposed AICPA statement, Noncompliance with Laws and Regulations, was issued June 6, 1975 (reference No. 3620). This statement needs to be broadened to include audits also performed under the GAO 'Yellow Book' standards. We suggest that (i) Section 1 of the proposed statement not be 'applicable only to examinations conducted in accordance with generally accepted auditing standards' but also include the Standards for Audit of Governmental Organizations, Programs, Activities and Functions, and (ii) notification requirements to third parties of non-compliance under Section 11 need to incorporate references on reporting to Governmental agencies which financially support, through grants and contracts, substantive operations or programs administered by the auditee.

"The draft policy statement by the AICPA on reporting noncompliance on financial matters is a 'step in the right direction', however, the policy does not cover all possible elements of the audit engagement. Definitions of three potential elements of an audit of Federally sponsored activities or programs at a grantee or contract facility are provided in the GAO 'Yellow Book. '

"As for notification to third parties, the proposed statement appears to include only regulatory agencies, such as SEC. In the interest of improved communications, an AICPA position requiring notification of noncompliance to concerned Federal and/or State program officials is warranted, regardless of the source of funds for payment of audit services. Generally, Federal/AICPA audit guides provide for such notification prior to issuance of the final report, if significant. Distribution of the final audit report, of course, is required to both the grantee and the responsible Federal program official.

"Notification policies for fraud (Item IV) and noncompliance should be addressed in a consistent manner. "

IRS

"The auditor should not be responsible for detecting adverse management behavior per se; the auditor would be responsible for detecting control breakdowns or ineffective or inefficient operating practices which may be symptomatic of managerial shortcomings. The scope of the audit report should clearly delineate the extent of his reviews in the audit engagement. If the auditor discovers adverse behavior and it significantly impacts on the reported financial and operating activities of the firm, this should be reported. "

VIII. The role of the auditor's report in communicating with users of financial information and possibilities for improving communication.

IRS

"The auditor's report is the link between the auditor and the user and as a result the report should be responsive to the needs of the user in a language understandable to the user. There is a definite need for more openness by the auditor with potential users. "

Labor

"The most diverse auditing work that can be found is the Federal Government. Accordingly, we need to acquire the best audit skills available. Otherwise opinions on financial statements will not provide protection to the user of the report. Also, simplification and standardization of format would lead to better understanding on the part of the user. "

Transportation

"The independent public auditor's (IPA) reports have contained too many qualified statements or opinions. If an IPA performs an audit using an audit guide provided by the Federal agency, the guide should be identified in the report and further qualification should not be necessary. "

IX. The effectiveness of auditing methods and techniques and possibilities for improving effectiveness.

Defense

"In our view, existing audit methods and techniques have proven effective as they relate to reviews of financial statement presentation; however, following our comments under Issue VI, auditors' effectiveness could be substantially increased by extending the audit scope, when appropriate, to include an evaluation of operating economy and efficiency. The effectiveness of operations auditing methods and techniques have been abundantly demonstrated by audit recommendations that have resulted in substantial cost reductions."

DCAA

"We in DCAA have long recognized that professional development, continuing education, and research in audit methodology are the best ways to improve audit effectiveness.

"To this end, we operate the Defense Contract Audit Institute, staffed with experienced auditors and training personnel and offering a varied curriculum....

"In addition to our in-house training programs, we use the educational and training resources of other Government agencies and the public sector to give employees the opportunity to increase their knowledge and capabilities....

"Realizing that research is a mark of professionalism, we have concentrated on audit methodology to assure our work would be performed through the most effective means available. This research led to breakthroughs in applying computer technology and statistical methods to auditing practices. It resulted in our pioneering the use of time-shared computer services to perform complex computations in statistical sampling, correlation and multiple regression analysis, learning curves, and work sampling or ratio delay analysis."

HEW

"The auditing methods and techniques used are generally adequate. However, in general, the quality of audit performance has to be improved. In many instances, although the methods and techniques used in performing the audit were adequate, the quality of the work

was not. A good example is the Equity Funding case. In that instance, all the accepted auditing methods and techniques were used but the quality of work was not adequate. Transactions which should have been questioned during the supervisory auditor's review, were accepted.

"There should be greater use of computer assisted audit techniques especially in those instances where audits involve large volumes of data processed by computers. In this respect, the AICPA should develop or sponsor computer assisted programs which would be compatible to all EDP machine makes and models. These programs should be designed to be used without requiring any changes in the computer audit program during application to the particular equipment used by the auditee.

"In terms of improving audit effectiveness for audits of Federal grantees and contractors, greater emphasis on communication is needed in preparation of the Federal/AICPA audit guide. Funding and compliance issues, as well as other audit elements applicable, should be expertly designed to maximize technical guidance and to adequately program for results. The currently limited number of Federal/AICPA audit guides should be expanded. "

IRS

"The auditing profession (AICPA, Institute of Internal Auditors, etc.) and other authorities should foster the independence of internal auditing within an organization and should encourage closer working ties between the internal auditor and the outside auditor in accordance with prescribed auditing standards. A strong, independent internal audit activity would provide another management control for the outside CPA to review. "

Transportation

"IPA audits for Federal purposes must increase the attention given to determinations of the reasonableness of costs audited and whether the costs are proper considering the particular grant project involved. "

Treasury - Revenue Sharing (Mr. Beuley)

"More effective use could be made of the computer as a tool to assist in auditing and analyzing results of audit findings. I would encourage expanded training and use of audit retrieval programs. "

- X. The effectiveness of the present process for establishing auditing standards and possible ways of making that process more effective or efficient.

IRS

"Have the business community (managers, financial analysts, bankers, government officials, etc.) contribute to establishing auditing standards."

Labor

"The GAO audit standards provide not only for financial and compliance audits, they also require efficiency and economy and program results reviews. To accomplish these standards a highly qualified auditor is required. Implementation of these standards has special importance to third parties. Third parties rely on the auditor's opinion in making investments and other financial decisions."

- XI. The relationship of the independent auditor to investors, creditors, the board of directors and its audit committee, management, and other interested parties, and the nature and extent of the auditor's responsibilities to those various parties.

IRS

"The auditor should have a participative or team-work relationship with all these parties since he may have to serve all of them in one report. Without compromising his independence, the auditor must 'open up' with these parties to show them what he plans to do, generally how he plans to conduct his review and request their input to better satisfy their needs. Since any of these parties may act on his report, the auditor must make a full disclosure of all significant information."

Treasury - Office of Audit

"I believe there are times when independent auditors tend to limit the full disclosure requirement by advancing the doctrine of materiality. Sensitive transactions are sometimes measured by their relative value influences instead of their absolute influences on report readers' reactions. This may be done to avoid embarrassing the clients or the auditors."

- XII. The effectiveness of present policies and procedures for maintaining the quality of audit practice, and the desirability of increasing information available to the public concerning a firm's quality review practices and other information that might bear on public confidence.

HUD

"We have had about 3,000 audits performed by public accountants in the past few years. The public accountants are engaged directly by the program recipient and the audits are made in accordance with an audit guide prepared by HUD. Generally, their work has been satisfactory, but we have had cases of poor performance.

"A. Failure of Public Accountants to Perform in Accordance with the Terms of Their Contracts...."

1. Late submission of reports
2. Required schedules or exhibits omitted
3. Opinion omitted

"B. Questionable Quality of Work...."

1. Inadequate planning, supervision, evidential matter, compliance with audit guide
2. Reluctance to increase scope
3. Failure to make full disclosure
4. Question of IPA's relationship to client and to Government
5. Insufficient work

"C. Inadequate Disclosure"

1. Incorrect reporting
2. Absence of disclosure
3. Incomplete reporting

(Two case studies of audits are included in HUD response.)

IRS

"The auditing profession must remove the shroud of mystery surrounding the work of the public accountant. For example, include brief summaries in the news media of audit engagements that made a positive economic or other contribution to a firm or of engagements refused by auditors because standards would have to be compromised."

Treasury - Office of Audit

"The independent auditor would be more effective if his engagement under contract with the Government required him to review his reports with the agency's audit office in addition to the client-officials who engaged him.

"Another method of strengthening the independent auditors' role would be to require submission of the draft report to higher level management for review, where the contractor is an operating element within a department or agency.

"Perhaps government agencies should take a page out of the book of current business practices and establish audit committees to make the final choice of the independent auditor. In business, this final choice is the duty of the board of directors or an executive committee of the board. The Federal Audit Executive Council should consider promoting such audit committees, one member of which should be the agency's highest level audit officer.

"In addition, the Council should, I think, promote the inclusion of a clause in auditing contracts requiring, at a minimum, that the agency's top audit office should receive a copy of the draft report and opinion. Such actions may protect the profession from embarrassment, and gross errors."

- XIII. The effectiveness of the present organizational structure of the auditing profession for regulating the practice of auditing and possibilities for improving that structure.

IRS

"More use of non-auditing individuals on the AICPA executive board and particularly on the State Boards of Accountancy to help dispell 'self-serving interest' image."

- XIV. The effectiveness of the present process for establishing and administering procedures for recognizing individuals as qualified to practice as independent auditors, including the educational process, and possibilities for improving that process.

Air Force

"We submit that Air Force internal audit experience satisfies the experience requirements for certification. At present, however, each state decides on a case by case basis whether it will accept Air Force (and other governmental) auditing experience, and if so, how much experience is required to equate to their public accounting experience requirements for certification. As a result, some Air Force Audit Agency auditors can become Certified Public Accountants while others cannot. We believe that standardization of the acceptance of governmental internal auditing, as well as standardization of the equivalency of such experience, would improve the process of recognizing individuals as qualified to practice as independent auditors."

Defense

"In our view, auditors' training should be extended to include operations auditing methods and techniques. Such training should include an introduction to industrial engineering techniques, basic production methods and processes, and an introduction to management and problems of other than a financial nature. Recognizing that auditors may call upon specialists in other disciplines to assist in performing operational analysis, it is not intended that they should become fully proficient in areas outside their primary responsibility. Rather, they should have sufficient training in other areas to recognize the need for assistance when required and to evaluate the effectiveness of such assistance."

HEW

"Current AICPA efforts to have the states modify their accountancy laws to conform with the model law recommended by the AICPA should eliminate the existing inequities among the states in certification practices.

"From the viewpoint of auditors concerned with government accounts or accounts having a significant government investment, the accounting curriculum should include more accounting courses related to government operations. The curriculum should include courses

relating to the various government fund accounting systems and to the bases for use of cost principles and overhead determinations applicable to Federal grantees and contractors. "

IRS

"The uniform CPA and CIA written examinations are good methods for determining a candidate's knowledge. Candidates to the auditing profession should also be required to possess a bachelor's degree from an accredited college and have successfully completed certain minimum academic requirements, including but not limited to accounting, data processing, report writing, auditing including internal auditing, management principles, statistical sampling, and auditor-auditee relationships. Contacts should be made with the academic community to ensure that curricula are updated to meet student needs. "

Labor

"The American Institute of Certified Public Accountants has established a uniform examination which is given by each of the 50 States and the District of Columbia. State laws dictate the eligibility criteria as to who are qualified to take the examination. The American Institute has also developed a model accountancy bill for use as state legislation. This appears to be a very satisfactory process to determine individuals who are adequately qualified. "

Transportation

"While the Washington based IPA project directors are generally very familiar with the particular requirements of the Federal agency, this knowledge does not always follow to the journeyman level auditors who perform the field audit work. "

Treasury - Revenue Sharing (Mr. Beuley)

"I believe the requirements to become a CPA should be standardized on a national basis. Every professional should be required to meet these requirements no matter where he resides or works. Our society is too mobile to continue with individual state requirements. I also feel that more states should accept Federal government auditing experience for the experience requirements."

Treasury - Revenue Sharing (Mr. Gary)

"There are almost as many procedures to recognize individuals as qualified to practice as independent auditors as there are states since these procedures are prescribed by state law. Some of them are quite satisfactory while others are completely indefensible.

"Much of the confusion that exists in this area is due to the CPA certificate being named as the licensing document. In some states, this prohibits those who are not or have not been engaged in public accounting from obtaining a CPA certificate. This is a completely unfair and indefensible situation which has a serious adverse effect on government accountants among others. Either the granting of the CPA certificate should be separate from the licensing to practice public accounting or experience other than that gained in public accounting (governmental in particular) should be accepted to fulfill the licensing requirement. "

- XV. The effect of nonauditing services, such as management services or tax practice, on the audit function and the possible need for restrictions on those services.

Government Printing Office

"I believe internal audit groups are better suited to perform operational or Management type audits. They have sufficient time to perform thorough, in-depth analyses and the question of independence is not as important to internal groups as it is to external auditors. On the other hand, we cannot overlook the economic considerations for the auditing profession. Management Advisory Services is a lucrative field and one in which the client can receive tangible benefits. One possible restriction might be that CPA firms will not be permitted to perform financial auditing and Management Advisory Services simultaneously for the same client."

IRS

"There is a risk of loss of independence by the auditor if he performs both auditing functions and management services. He could be in a position of designing a system in one year and auditing the effectiveness of that system the following year. The auditor should not do both for the same client. There appears to be little or no effect of the tax practice on the audit function."

Justice

"Noticeably absent from the Code of Ethics is a prohibition against a firm serving in a dual role as audit agency, for both client and government."

Treasury - Revenue Sharing (Mr. Beuley)

"I believe the public is concerned a great deal about independence when a firm does a great deal of nonauditing services for the same firm that they audit. I think we should consider restricting some of these services or establish specific guidelines to ensure there is no conflict of interest. Also, the public should be educated as to the controls established to ensure that there is no conflict of interest."

XVI. The effect of the present process for litigating claims against auditors and the possibility and desirability of changes in that process.

Treasury - Revenue Sharing (Mr. Gary)

"The rash of suits against CPA firms in the past few years, the completely unfair interpretations that judges who are lawyers, not accountants, have made of accounting principles and the unreal liabilities both civil and criminal that have been assessed against CPAs during the last few years, if continued, will completely destroy the practice of public accounting. This is, in my opinion, the most serious problem that the practice of public accounting faces. It is as threatening to public accounting as similar malpractice suits are to the medical profession. At a time when CPAs are being encouraged to broaden their practice to include forecasts and management auditing, they must live in fear of even expressing their opinion on facts. This utterly discourages the basis of progress in any profession.

"It is utterly ridiculous for a CPA who might receive a \$100,000 fee to be liable to a third party (stockholder who he has never seen) for \$30 million. Moreover, there is good reason to believe that CPAs have been found guilty of criminal acts as a result of only poor judgment on their part.

"Unless the judges can understand that a CPA is not a guarantor and a CPA's liability can be limited to some figure that is reasonable in relation to the fee that he receives, it is doubtful if the practice of public accounting can survive. If so, is there any substitute for the CPA's opinion on financial statements in terms of providing the investor with the assurance he needs to risk his capital?"