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ARTICLES

Auditing the Oversight of Outsourced Activities

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Auditors can add value to organizations by assessing the fit between needed activities and outsourcing agreements (contracts). In government and private industry, audit techniques (including performance audits in accordance with government auditing standards) can identify and recommend improvements to internal contracting processes.

Management may not be aware that contracts can be a means to transfer risk to the contractor, and may view contracts merely as means to acquire needed resources. In government and in private organizations, risk transfer may be unclear to stakeholders and to contractors, since errors, mistakes, or problems made by the contractor could be confused with errors, mistakes, or problems within the organization. For example, stakeholders may see the organization as responsible for the failure of contracted services, even in cases where the primary responsibility for the failure rests with the contractor. Even though management may not be able to guarantee the success of contracted activities, management can take the following actions to better control the risks from contracted activities:

(1) Keep contractors fully accountable to deliver what they promised,

(2) Include clearly identified deliverables and deadlines,

(3) Include a statement in the contract terms explicitly defining the intent of the contract, what is expected, and who is responsible, and

(4) Arrange contract payments to match contractor performance.

Less risk is transferred when the lines of accountability are blurred. For example, if a homeowner needs a new roof and hires a roofing company, the homeowner probably assumes that the roofing company will take the risk of completing the roof on time and within its bid. However, if the homeowner agreed to share the roofing work with the contractor, the homeowner might not transfer all of the risk to the contractor. What could have been a problem “owned” by the contractor (like not finishing the roof on time) could, under a partnership arrangement, be viewed as partly the fault of the homeowner. To avoid similar issues, auditors can recommend that management set clear expectations for risk transfer, and that management only sign contracts when risk is explicitly assumed by contractors.

Most contract auditing focuses on compliance with the terms of the contract, and on legal requirements and on allowable overhead rates. While these issues (compliance, legal sufficiency, and allowable overhead) are important and worthy of validating, they may not constitute a complete review of the contract. Typical contract reviews also fail to assess the ultimate success of the contract, since a contract could be “legal,” have allowable rates, and may be complete according to the terms of the contract, but still fail to meet the needs of a project owner. Specifically, a “legal” contract may not be a good, efficient, or appropriate contract, and a contractor could charge an appropriate overhead rate, but still could fail to meet management's needs. Internal audits can ask questions such as:

- Was the contract necessary?
- Did management effectively transfer risk to the contractor?
- Did the contract achieve management's goals?

Internal auditing can also focus on reducing risks to management by better informing management of the true extent of current reviews. For example, management may believe its contracts are in good shape because many contracts are reviewed in the following typical ways:

1. A pre-award review for overhead rates,
2. A legal sufficiency review for contract terms, and
3. A contract audit for compliance with contract terms.

These typical reviews are appropriate, and they each add value to the process in the specific areas they examine. But even taken together, these three typical reviews of contracts may be insufficient to assure management that it has the right contract at the right time, or that management was successful in transferring risk. Internal audits of outsourced activities can add value well beyond the typical reviews, and can even expand the scope of the review beyond the traditional "on time, on budget" check.

Confirmation that a contracted project is "on time, on budget" is subjective, since contract changes (often called "change orders") can alter the deadlines and budget of a contract. For example, a $1 million, 6-month project could actually end up costing $3 million and taking 10 months. As long as the contract was changed properly, an "on time, on budget" check would conclude that the contract was on time and within its budget, even though it far exceeded its initial estimates.

In conclusion, contract owners and managers can make the following improvements to enhance their oversight of contracts and to better ensure that contract terms are met:

- Contractors would be fully accountable for contracted goods and services (meaning that "risk transfer" to the contractor occurred).
- Contracts would include clearly identified "deliverables" and deadlines, so clearly defined that an independent reviewer could determine whether the contract terms were met. Vague contract terms confuse risk transfer and also make the contract less auditable after the fact.
- Contracts would include an "intent statement." Intent statements should include plain language descriptions of what is expected and when it is due.
- Link payments to contractor performance. Management should not pay for what it doesn't receive!
- Better distinguish "requests for proposal" and "requests for information." Specifically, ensure that early narrowing in the contract process does not rule out potential competitors who offer a similar item or service.
- Keep contract types distinct and avoid "partnership" arrangements unless explicitly defined.

Internal auditors can also use these recommendations as a gauge to measure current contracts against, and can recommend these and other improvements to management to enhance the precision and the transfer of risk in future contracts.

Communication Skills Needed by Entry-Level Accountants

By David Christensen and David Rees, Southern Utah University

Numerous surveys have established the importance of communication skills for entry-level accountants, but none have identified the specific skills needed. Several months ago, many of you offered your input by completing a Web-based questionnaire, and we are sharing what we learned from you. In the survey, you were asked to (1) rate the importance of selected communication skills and (2) indicate your level of satisfaction with how well entry-level accountants are being prepared by universities in these skills.

Category	ALL	Percent
All	2,181	100%
Business Activity		
• Assurance/Tax	1,557	71%
• Finance (management accounting)	576	26%
• Other (e.g., government)	458	21%

The sum of the percentages in Business Activity exceeds 100% because some respondents checked more than one business activity.

Here are some of the demographics of the respondents. We received a total of 2,181 responses from members of the AICPA and another professional organization. In the chart below, you will see the skills that you rated the most important and your satisfaction with how well entry-level accountants are prepared.

Based on these findings, we will be communicating with accounting educators on how important these skills and the others surveyed are and how they need to be emphasized throughout the curriculum.

As a supervisor of entry-level accountants, you have a responsibility to increase the technical skills of your staff. It is also very important that you continue to nurture the development of the communications skills that are being emphasized in the university. To accomplish this, you should:

Communication Skills	Importance	Satisfaction
-Listens effectively	4.51	3.04
-Uses correct grammar in both spoken and written communication	4.48	2.96
-Writes well — clearly, concisely, correctly, completely	4.42	2.68

Importance was rated on a five-point scale, where 1 = unimportant, 2 = somewhat unimportant, 3 = important, 4 = very important, and 5 = extremely important. Satisfaction was rated on a five-point scale, where 1 = very dissatisfied, 2 = somewhat dissatisfied, 3 = neither satisfied nor dissatisfied, 4 = somewhat satisfied, and 5 = very satisfied.

- Encourage presentations at meetings within the organization.
- Provide opportunities for your staff to write memos and reports. The more experience they have, with your feedback, the faster their skills will develop.
- Correct errors in spelling and grammar and let your staff know the importance of good diction.
- Teach your new staff how to review their analyses and work papers for organization, completeness, and conciseness.
- Emphasize the importance of listening and considering alternative viewpoints.

Strong writing is one of the most important skills repeatedly cited by business and corporate leaders. Command of the language and the ability to make informative, interesting and persuasive presentations are key components of an employee's and employer's success.

AICPA National Business Valuation Conference

Join us this year as we make our way to majestic New Orleans for the AICPA National Conference on Business Valuation. The conference is being held November 18-19, 2002 at the New Orleans Marriott. This one-of-a-kind event, featuring an outstanding line-up of experts in the business valuation arena, will highlight the latest technical issues and practice management developments.

Whether you are a novice or an advanced valuation practitioner, this event covers everything from core competencies to cutting-edge issues and in-depth analysis to further any level of expertise.

You can choose from the tracks that match your interest and experience level, such as:

CORE CASE STUDY: This year's core track includes an interactive case study that coordinates eight of the core track sessions. This case study is designed to appeal to participants desiring an application of the subject materials, as well as those with limited or no appraisal experience. The eight sessions are designed to present the major areas involved in a “start-to-finish” business valuation and will include a discussion of current valuation events and trends, and conclude with an application of the case study to the respective session topic.

HOT ISSUES: Valuation is a work in process — theories are being tested and challenged on a daily basis. The hot issues track will present “burning” issues in the business valuation field. This track is designed for the more experienced practitioner and is meant to explore developing issues in the field.

LITIGATION: Are all valuations generic? Just because you have done valuations for tax-related matters or divorce cases, does it mean that you are prepared to take on other litigation matters? The answer is an emphatic NO! This track is meant to provide some insight into the specific nature of valuation and damage cases in the context of litigation so that you don't get caught without the knowledge you need to be qualified to work in this arena.

VALUE-ADDED SERVICES: As the business valuation niche becomes more competitive, we need to offer additional services to our organizations. This track is designed to help business appraisers think outside the box. During these sessions, you will explore ways in which you can stretch your valuation expertise into other potential value-added services.

Conference highlights include:

- Ever take the opportunity to step outside of your daily routine and take a really close look at what you do? LaughingStock Comedy Company will deliver a customized comic look at the culture of business valuators.
- Hear from one of the nation's most elite lawyers, Roger J. Dodd, who will discuss issues related to advanced cross examination.
- NYU Stern School of Business Professor, Dr. Aswath Damadoran, will explore the question: “Can you value what you can't see?”

For more information or a conference brochure, visit www.cpa2biz.com.

Survey on Performance Measurement Systems

Periodically, we encourage you to complete surveys that are being conducted by professors and other organizations. By taking a few minutes of your time, we can all gain access to the best practices and newest trends that help us in our day-to-day activities. Prof. Laurie McWhorter at the University of NC–Charlotte is conducting one such research project on performance measurement systems. We will report the findings in future issues of The CPA Letter.

The goals of this research are to enable you to (1) compare your system with current practices, (2) view the perceived level and effectiveness of performance measurement system implementations, as well as the perceived weaknesses, and (3) learn about the perceived benefits of various performance measurement systems.

To complete the survey, which will take you only 15 minutes, type the following URL into your browser: www.uncc.edu/LMcWhort/AICPA.htm . Userid: lmcwhort_cr, Password: dg7014. Or, if you would prefer to complete a hard copy of the survey, contact Laurie McWhorter at 704/687–4493 or LMcWhort@email.uncc.edu.

AIMR Issues Draft `Research Objectivity Standards' for Sell-Side and Buy-Side Investment Firms, Public Companies and Media

The global Association for Investment Management and Research issued draft "AIMR Research Objectivity Standards" setting forth ethical business practices that all key market participants throughout the world — including public companies and investment-management firms — should follow to create an environment that promotes objective securities research and analyst independence.

AIMR, a non-profit professional association of 58,000 securities analysts, fund managers and other investment professionals in 112 countries, issued the proposed AIMR Research Objectivity Standards for a 90-day public comment period that will end Oct. 17. AIMR will then finalize the standards and promulgate them worldwide. The draft standards are available on the AIMR web site at www.aimr.org, along with instructions for submitting comment.

AIMR's proposed standards prohibit both public companies and investment-management firms from retaliating against research analysts who issue undesirable recommendations or ratings on corporate issuers. They also require public companies and investment-management firms alike to establish formal written policies supporting independent and objective analyst research and to have a senior corporate officer publicly attest at least annually that the company or firm is adhering to the policy.

Public-Company Standards and Guidelines

The significance of external pressures on analysts was demonstrated clearly through a Reuters survey in 2001 that found that 88 percent of analysts surveyed said they believed the companies they cover would retaliate if they issued a sell recommendation on the company's stock. Many feared the companies would try to minimize the analyst's access to the company and its executives, would cut their firms out of future investment banking deals, or would even sue them or try to get them fired.

In addition to the proposed standards for public companies, AIMR issued guidance stating that securities issuers:

- should not file legal suits against research analysts for their recommendations.
- should not make accusations against research analysts in the media.
- should not seek to review a research analyst's report in advance of publication. Issuers may be asked to fact-check data, but any corrections should be communicated not to the analyst but to the compliance or legal department of the analyst's firm.

Buy-Side Standards and Guidelines

Among other things, buy-side firms that adopt the standards must:

- prohibit employees from pressuring sell-side analysts to issue favorable research on the securities in the client or firm portfolios they manage. Specifically, buy-side employees must be prohibited from reducing or eliminating their firm's business with a brokerage firm — or threatening to do so — in an effort to secure a favorable rating on a security.
- prohibit employees from encouraging the public company that is the subject of the research to retaliate against a sell-side analyst for issuing an undesirable recommendation.
- provide full and fair disclosure of all conflicts of interest of the firm or its investment professionals. AIMR lists 10 examples of relevant disclosures, such as whether the firm has an investment advisory relationship with any corporate issuers, and whether investment managers have received “material” gifts from a corporate issuer.

As an additional recommended practice, AIMR said firms whose employees make public presentations should make available to the audience written reports summarizing the research and giving a “reasonable and adequate basis” for the recommendation.

Sell-Side Firm Standards

Among other things, sell-side firms that adopt the standards must:

- establish rating systems that help investors assess the suitability of a security to their own unique circumstances and constraints, rather than taking a “one size fits all” approach that treats all investors alike.
- align analyst compensation to the quality of research and the accuracy of analyst recommendations over time.
- segregate research from investment banking in ways that ensure that investment banking does not influence research or the resulting recommendations.
- fully disclose all conflicts of interest of both the analyst and the firm, especially whenever analysts discuss their research and recommendations in public settings. (AIMR gives at least 15 specific recommended practices for disclosure in the research report, including specifics on any client or investment relationship with the covered company that the firm may have.)
- not allow analysts to buy or receive “pre-IPO” shares. However, firms may permit analysts to own shares of the companies they cover, as long as analysts are prevented from selling the stock when the analyst has a “buy” or a “hold” on it, or from otherwise trading against their own recommendations. Firms must also prevent employees from “front running,” or trading in advance of issuing research reports.

News-Media Standards

The AIMR standards also call on the media to facilitate disclosure of any conflicts of interest of the investment professionals they interview. To conform with the AIMR Research Objectivity Standards, news media would need to establish formal written policies for the handling of these disclosures and implement supervisory procedures to ensure that the disclosures reach the media audience.