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# Auditing Standards

## Reflective or Prospective

By Robert Hill and M. Zafar Iqbal

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Auditors are required to adhere to generally accepted auditing standards; these standards determine the manner in which they perform their examination to provide a basis for representations with respect to financial statements. They are guided by ten standards dealing with areas such as technical training and proficiency, independence in mental attitude, due professional care, field work, and reporting. The Statements on Auditing Standards provide important interpretations of the standards. Moreover, Rule 202 of the Code of Professional Ethics prohibits a member of the American Institute of Certified Public Accountants (AICPA) from permitting "his name to be associated with financial statements in such a manner as to imply that he is acting as an independent public accountant unless he has complied with the applicable generally accepted auditing standards promulgated by the Institute." [AICPA, 1978]

The well-publicized financial disasters that have hit some companies in recent years have drawn attention to the auditing standards used by certified public accountants to control the quality of independent audits. A logical question which arises during this proc-

ess of contemplation is: Are auditing standards prospective or reflective? The answer can provide useful insights into the approach taken by the profession to assure high quality audit work.

### Reflective vs. Prospective Standards

There are significant differences between the two approaches.<sup>1</sup> Reflective standards are based on hindsight. Past standards are modified or discarded when proven to be unsatisfactory. The new standards, which replace past standards, are either to correct existing deficiencies or to fill some void. The influence of old standards on development of the new is direct and obvious. At best, reflective standards are the outcome of a brush-fire approach.

Prospective standards are, by their nature, future-oriented. They are formulated through exercise of foresight and take into account consequences of expected changes in environmental factors. This entails an approach which requires vision. The product of such an

<sup>1</sup>See Dale Gerboth, "Muddling Through with the APB" (*Journal of Accountancy* (May 1972) for a comprehensive discussion of the relative merits of these two approaches in connection with the setting of accounting standards.

outlook is a set of standards built on a sound philosophical and conceptual foundation. Such standards are integrated and comprehensive, rather than narrow and fragmentary.

### Importance of Auditing Standards

Before commencement of discussion on the main issue it is important to underline the dual role played by auditing standards. These standards serve users of audited financial data as a statement of the quality of work performed. They also serve the auditor by providing a guide for measuring actions throughout the course of an engagement.

From an auditor's point of view, auditing standards are criteria controlling the quality of performance; they serve as a guide to action. From the perspective of the user of financial statements, auditing standards convey the competence of the examination which formed the basis for the auditor's opinion.

### Reflective Standards—A Hypothesis

A review of the development of auditing standards in the United States leads to the observation that, until the present time, most statements on auditing standards have been reflective rather than prospective. Collectively the profession has reacted in response to external pressures instead of taking the initiative. The purpose has been to engage in defensive measures—not to assume a leadership role.

A hypothesis can be advanced on the basis of the profession's record in this area. Perhaps auditing standards have not been prospective because most professionals have erroneously believed in the past (and some still continue to be convinced) that auditing is one of the many segments of the accounting discipline. Therefore the development of accounting principles has almost singularly been the area of emphasis and the object of attention. Implicit in this belief is the assumption that "fair" presentation is dependent solely on consistent application of generally accepted accounting principles. Consequently the auditing standards have been accorded a secondary and subordinate position.

But, as Mautz and Sharaf have pointed out, auditing has a status as

a discipline by itself.

*The relationship of auditing to accounting is close, yet their natures are very different; they are business associates, not parent and child. . . . Auditing must consider business events and conditions too, but it does not have the task of measuring or communicating them. Its task is to review the measurements and communications of accounting for propriety. Auditing is analytical, not constructive; it is critical, investigative, concerned with the basis of accounting measurements and assertions. . . . Thus auditing has its principle roots, not in the accounting which it reviews, but in logic on which it leans heavily for ideas and methods. [Mautz, 1961]*

## Sources of the Problem

As mentioned earlier, the profession has taken a piecemeal approach. First of all, most members of the AICPA's group that sets auditing standards, the Auditing Standards Board, are CPAs in public practice. Their input, determined mainly by their professional backgrounds, is unidimensional. It suffers from the absence of broad participation by people with diverse backgrounds. Practicing CPAs for the most part have adopted a defensive approach to the development of auditing standards: Their overriding concern to guard against litigation (though understandable) provides a narrow perspective for the development of standards.

Secondly, the Auditing Standards Board consists of members who serve as volunteers on a part-time basis. All the arguments which were successfully made against the Accounting Principles Board's organizational structure may easily be directed toward this arrangement. It also substantiates the point made earlier regarding the secondary place awarded to auditing standards in comparison with accounting principles. In contrast to the Auditing Standards Board, members of the Financial Accounting Standards Board serve on a full-time basis and are compensated rather handsomely.

Finally, the main problem appears to be attitudinal: undiscerning acceptance of the reflective approach as the correct approach. The following statement made by one of the Big Eight in response to the *Accounting Establishment* [U.S. Senate, 1976] is representative of prevalent thought:

*When conditions have indicated weakness in the auditing standards, the profession has responded by developing appropriate professional guidance. [Young, 1977]*

Unfortunately, the deficiencies in existing auditing standards are not usually recognized by the members of the profession. Rather, the flurry of activity to identify problem areas follows pressure exerted by external sources. Most often the incentive for action (or rather, reaction) comes from the following: business scandals and litigation involving liability damages, the Securities and Exchange Commission (SEC), and the United States Congress.

1. **Litigation.** The influence on auditing standards exercised by the outcome of various liability cases (both court decisions and out of court settlements) is apparent. All standard auditing textbooks contain extensive coverage of various business scandals, related litigation, and resultant changes or additions to auditing standards. Similarly, practitioner-oriented professional journals routinely discuss their impact at length. Since the well known McKesson and Robbins case in 1939 there has been an ever increasing list of important legal cases which have left their imprint on auditing standards.

2. **The SEC.** The influence of the SEC also widely manifest in auditing literature. The SEC has expanded the requirements for financial information and provided impetus for many disclosures. Accounting Series Releases issued by the SEC cover a wide variety of topics.

The pace with which these releases have accelerated is significant.

Time interval	Number of releases
1934-1964 (31 years)	100
1964-1973 (9 years)	50
1973-August 1981 (7 <sup>2</sup> / <sub>3</sub> years)	147

Obviously in recent years the SEC has assumed a more activist posture. Perhaps it is partly due to the criticism from those who allege that the agency has been soft on the accounting profession.

Historically, AICPA pronouncements on auditing illustrate the extent of the influence exerted by both the business scandals and the SEC on the development of auditing standards. The first official AICPA statement on auditing, "Extensions of Auditing Procedure," (1939) was a direct response to the McKesson and Robbins scandal. In

## The auditing profession has engaged in defensive measures

1976 the Auditing Standards Executive Committee (predecessor to the Auditing Standards Board) issued SAS No. 16, "The Independent Auditor's Responsibility for the Detection of Errors and Irregularities," the same year, SAS No. 17, "Illegal Acts by Clients" was issued. It would not be presumptuous to state that the disclosures of corporate illegal payments as well as pressure from the SEC were instrumental in bringing about issuance of these two standards.

3. **U.S. Congress.** In the past few years, auditors have been subject to considerable criticism from some members of the United States Congress.<sup>2</sup> Reports of the Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs—United States Senate, and the hearings conducted by the House Subcommittee on Oversight and Investigation have made the profession acutely aware of the credibility problem it faces among some sectors of society. [U.S. Senate, 1976 and 1977] While proposed legislation to regulate the activities of public accounting firms practicing before the SEC was not adopted, [Haskins and Sells, 1978; Price Waterhouse, 1978] the possibility that such legislation could be reintroduced remains.

<sup>2</sup>Popular business periodicals often elaborate on the direct impact of the SEC and Congress on the public accounting profession. For example, on March 7, 1978, *The Wall Street Journal* (p. 13) noted, "Responding to pressures from Congress and the Securities and Exchange Commission, leaders of the American Institute of Certified Public Accountants plan to recommend key changes in the structure of the Institute's new section for firms that audit publicly held corporations." The article further stated that "The proposed changes come at a time when accountants are under close scrutiny in Congress and at the SEC."

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## Auditing is a discipline in itself—not a segment of accounting

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### Some Recent Developments

In *Report, Conclusions and Recommendations* the Commission on Auditors' Responsibilities (Cohen Commission) recommended the establishment of a full-time, paid body empowered to set auditing standards. [AICPA, January 1978] Acceptance of this proposal would have been a step toward the prospective approach. Unfortunately, the special committee appointed by the AICPA to study the Cohen Commission proposals related to the structure of the Auditing Standards Executive Committee rejected the recommendation.<sup>3</sup> One of the reasons cited by the special committee was that the need for such a full-time board is "not at all obvious." [AICPA, March 1978] In a subsequent action the Council of the AICPA approved restructuring AudSEC generally along the lines of the report of the special committee.

*The present 21-member Auditing Standards Executive Committee ("AudSEC") will be replaced by a 15-member auditing standards board. Like AudSEC, the new board will be a part-time volunteer group of AICPA members, rather than the full-time body, possibly including non-*

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<sup>3</sup>See Richard B. Lea's recent article [Lea, 1981] for a thorough analysis of the profession's action (and in some cases, inaction) in response to the various recommendations of the Cohen Commission.

*CPAs, envisaged by the Cohen Commission. [Price Waterhouse, 1978]*

There have been some positive developments which may have far reaching impact on the future development of auditing standards. The most encouraging of these is the increased emphasis being given to auditing education. Accounting curricula are being revised in some schools to recognize the field of auditing as a separate area, instead of a one-course adjunct to the accounting program. [Smith, 1978] The introduction of professional schools of accountancy may provide an environment conducive to an expanded role for auditing education in terms of the number of course offerings as well as in-depth treatment of the subject matter. [Lea, 1981]

Another important development is the increasing interest in research in auditing. One indication is the establishment of an Auditing Section of the American Accounting Association. Also, at least in one case, a major CPA firm has been financing numerous research projects through grants [Peat, 1976], which may result in the development of prospective auditing standards.

### Conclusion

Auditing standards in the United States have been the product of a reflective approach. Their development, modification, and deletion is dependent on stimuli which have external origin, most notable being the business scandals, the Securities and Exchange Commission's rulings, and pressures from the U.S. Congress. Absence of the prospective approach may be attributed to the misconception that auditing is a part of accounting, and therefore has a secondary position. Some recent developments, most notably a greater interest in research in auditing topics, are steps in the right direction.Ω

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