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Some Historical Auditing Milestones; An Epistemology of an Inexact Art

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To accept an assignment to write of history is in many ways more foolish than to attempt to be a soothsayer. When one forecasts, the reasonableness of his assertions can be debated but only substantiated by the passage of time, at which point one can blow the dust off the forecasts (if they proved reasonably accurate) and point with pride to such clairvoyance. If the forecasts missed the mark, one can let the earlier assertions rest forgotten unless reminded thereof, at which point a cloudy crystal ball can be argued to have been expected given the vagaries of such a changing, dynamic environment.

On the other hand, a cloudy crystal ball is difficult to explain when one examines events of years past, for there are records, memories, and earlier expressed opinions as to history. It is not possible to wait for the passage of time hoping to receive plaudits for reasonable assertions, or brick-bats, if observations are different than those subject to historical "verification" or at variance from those of the reader's perceptions.

The historian hopes to make his contribution in one of three ways. Of greatest reward is the uncovering of some new artifact or information which will not only add to the store of knowledge, but help in explaining some facet of our heritage which heretofore had remained unknown and as frustrating as a missing piece from a jigsaw puzzle. A lesser, but nonetheless satisfying endeavor, is to start with the known historical body of knowledge and successfully structure some new theory permitting a greater understanding of one's heritage or present behavior. Of least satisfaction is to attempt to order given knowledge in a fashion in which it has not previously been ordered, hoping to enhance the understanding of the past and permit greater perspective of today's moment in history, and hopefully, a better basis for speculations as to the future. It is this latter contribution that we hope to make in this paper, an epistemological approach, that is, the study of the nature and substance of audit history with the objective of better understanding the evolutionary process which shaped the present state of the art and may influence future occurrences.

Difficulties with an Epistemological Approach to Auditing History

Three identifiable steps must occur to successfully carry out an epistemological study: first, the important, influential events must be identified and segregated from trivial events. This first step is critical, yet difficult, for it is easy to make an error of commission and include some event which in others' judgment should not be considered, or to make an error of omission and fail to include in one's consideration some important influential factor of history.

The second step to perform is to order the identified important historical variables in some manner which can lead to the necessary third step, an interpretation of the events and their ordering. This second step is also difficult, for the historian is plagued with uncertainties as to the *cause* or *motivation* underlying the occurrence of a specific event, the actual *importance* of the event at the time it occurred, as well as the true *influence* of the event on the evolution of the art. It must also be recognized that the ordering process itself structures the analysis and interpretation of historical events. These difficulties are not unique to the study of auditing history, but plague the student of the history of any art or science. Certain other difficulties seem more uniquely associated with the study of auditing history, especially in viewing the so-called auditing "milestones."

We first encountered the milestone in France (*milleborne*), where it is used as in other principally European countries to mark orderly, measurable steps to a predetermined goal (mileage traveled from a given city and remaining to another specified city). It stretches our imagination to argue that there have been orderly and measurable happenstances in audit history which can be stated to have occurred with some specific goal in mind. Auditing evolution has been irregular, responding to pressures from within the profession and the environment, with no specific goal or goals which have been historically consistent or even well articulated, and with a distinct lack of specified hurdles against which progress can be measured. Perhaps this is understandable, since auditing is truly a service function, responding to demands for its service by adjusting its "theory" and tools of practice as needed to satisfy the changing needs of its customers. The service nature of auditing and the audit process are what encourage us to describe the practice of auditing as an "inexact art."

Art has been defined as a skill in performance acquired by experience, study, or observation. It is also defined in *Webster's Seventh New Collegiate Dictionary* as (a) an occupation requiring knowledge or skill, (b) a system of rules or methods of performing certain actions, and (c) systematic application of knowledge or skill in effecting a desired result. Certainly, these definitions describe the auditing process even though the auditor may use the scientific method of reasoning from an hypothesis and collecting and interpreting data in order to affirm, deny, or modify the hypothesis. The use of such a "scientific" tool as probability sampling does not change the fundamental nature of the auditing process; a process which cannot but be described as an art, and an inexact one, at that. This inexact nature of the audit process, the evolution of the art in response to internal and external influences, and the lack of a consistent and articulated set of goals, render difficult any epistemological study. Nonetheless, the major factors influencing audit evolution and the important

events that could be identified made possible some structure and ordering of auditing "milestones."

Choosing a Structure for Ordering Historical Audit Events

One possible approach, and the one which we first attempted, was to make an extensive review of the literature and prepare a chronological inventory of important events in the history of auditing. Since the purpose of this paper is to make some observations about the milestones in the development of the profession in the United States, and since earlier audit history is reasonably well chronicled, we began our survey with the literature which could be reasonably argued to be representative of, or contributory to, the profession in this country. Once completed, however, we found that a sequential inventory of important publications and events was less than satisfactory, not only because of the uncertainties arising from fears of possible errors of omission and commission, but because of the lack of any apparent order or logic to the listing. A second problem is that any such list ignores cause and effect relationship, tending to concentrate on the "effect" side of the equation, while the "cause" is the most interesting if one is seeking to rationalize the occurrence of events or to use history in a predictive fashion.

A more exciting approach to ordering audit history would be to focus on the giants of the profession and their contributions. This has partially been accomplished in the form of several publications devoted to the lives of both academicians and practitioners. It is much more interesting to study people than events, but such an approach can only result in a disjointed survey since many of the important factors which shaped the profession were unrelated to individuals, being of economic, social and technological origin.

An interesting "macro" approach is to attempt to identify the major socio-economic-technological environmental influences on the evolution of the auditing profession along with the identification of the response of the profession to those influences. Such an approach is quite a chore, for two reasons: first, cause and effect relationships such as these are difficult to establish in an *ex-poste* manner, especially when one realizes that these relationships were often not understood or documented at the time, much less decades later, and second, because there is not always a clear cause which can be associated within a given time period with an important event which occurred.

Another method of ordering historical milestones is through a characterization of the profession by looking at the major "eras" through which it passed in its development. Such an era classification is also difficult, since many events are not subject to placement into neat little boxes of time or character, in the sense that they are evolutionary in nature. A significant lead-lag problem also exists, since certain environmental influences do not make their presence known in the professional literature or practice until long after the cause for the evolutionary change has vanished or diminished in importance.

In reviewing the chronological inventory of events which we prepared, and in stepping back to reason therefrom, we decided that the last two approaches mentioned above would be most interesting and most useful in attempting to generalize about our professional heritage. The next two sections of the paper present these two orderings of auditing milestones, with the era classification

provided first and the socio-econo-technological environmental (in a cause and effect relationship) presented second. In a sense, this provides two different ways of viewing the same history. Since any ordering is a matter of choice, the use of two alternative methods of classification permits us to test how important the choice itself is in making generalizations of relevance as to the current status of the profession and/or assertions as to the future.

Auditing Milestones Classified by Era

Since we are dealing with the epistemology of a profession, it makes sense to view its evolution in terms of the major periods of professional change or growth. We have selected the following five classifications as being a useful description of the eras of auditing evolution: "Emergence," "Consolidation," "Technology," "Professionalism," and "Conflict and Uncertainty."

The various eras can be described generally as follows:

Emergence	The birth and early development of the auditing profession in the United States.
Consolidation	The move toward combination, uniformity and strength.
Technology	The interest in and sometimes preoccupation with audit tools and techniques, especially the so-called "scientific" tools.
Professionalism	The assumption of responsibility for shaping the destiny of the profession rather than responding to outside pressures for change; organizing and bonding together for influence.
Conflict and Uncertainty	Serious questions about the nature and scope of audit content and responsibility create internal conflict within the profession.

The specific important audit milestones which we would attribute to each of the five eras which we isolated are shown in the table following.

AUDIT MILESTONES CLASSIFIED BY ERA

Era	Audit Milestones
Emergence: Late 19th Century to 1920	<ul style="list-style-type: none"> • The expansion of business enterprises and the great influx of foreign capital into the United States in the late 1800's created the need for a body of trained accountants. • The American Association of Public Accountants was formed in 1887. • The State of New York passed the first public accounting law in the United States in 1896. • Mounting credit problems in the early 1900's caused bankers to pressure corporations to have their balance sheets "certified." • The literature of auditing began to mature. <i>The Journal of Accountancy</i> commenced publication in 1905. In 1914 Robert Montgomery published the first United States auditing textbook, an adaptation of Dicksee's 1892 English text. • In 1916 the American Association of Public Accountants was re-organized and became the American Institute of Accountants. The change reflected the movement of the

Era

Audit Milestones

profession from a very regionalized apparatus to a truly national organization, promoting uniform goals and standards.

- The adoption of the Corporate Income Tax in 1917-1918 caused the demand for accountants' services to soar.
 - The growth of external pressures caused by the growing number of business failures and the extreme lack of uniformity of financial statements led to the publication of "Uniform Accounting: A Tentative Proposal Submitted by the Federal Reserve Board" in 1917.
- Consolidation:
1929 to Early
1940's
- In 1929 a special committee of the AIA undertook a major revision of the 1917 Federal Reserve Board audit guidelines to reflect the growing importance of profit and loss statements, include evaluation of internal control as an integral part of the audit, and remove many of the inconsistencies in recommended audit procedure.
 - Public reaction to the stock market crash and the depression led to expanded governmental and other regulatory control over securities transactions and financial reporting. The SEC became a powerful entity with the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. The New York Stock Exchange required audits for all listed companies in 1933.
 - In 1930 the AIA appointed the first committee on cooperation with the stock exchange.
 - In 1931 the *Ultramares* case established the limited liability of auditors to third parties not "in privity."
 - The McKesson-Robbins scandal in 1939 revealed the inadequacies of accepted methods of auditing inventories and receivables, and led to the formation of the special AIA committee on auditing procedure, which published "Extensions of Auditing Procedure" in May of that year. The committee was made a standing committee, and it soon commenced regular promulgation of the "Statements on Auditing Procedure."
- Technology:
1950's
- This era was primarily occupied with the development of more sophisticated tools by which the audit process could be improved:
 - The introduction of computers and the steady conversion of business data management to Electronic Data Processing modes led to the development of specialized methods for auditing the computer and using the computer to increase audit efficiency.
 - The refinement of statistical techniques led to increasing usage of statistical sampling.
 - Formal, quantitative evaluation of internal control was proposed as a means of determining the extent of detailed testing that was required.
 - The recognition of the applicability of the specialized abilities of accounting professionals to all areas of business management led to the emergence of management services.

Era

Audit Milestones

Professionalism:
1960's

- The Committee on Auditing Procedure continued to gain influence by further clarifying the auditor's responsibilities and the scope of his examination.
- The profession assumed increasing responsibility for shaping its own destiny by interacting with external professional and regulatory agencies in attempting to improve the uniformity and information potential of "generally accepted accounting principles."
- The Accounting Principles Board emerged as a powerful policy body.
- The concepts of management auditing were developed.
- The techniques of analytic review and of continuous auditing were refined and put to increased use.

Conflict and
Uncertainty:
1970's

- Public criticism of accounting principles and of the limited extent of disclosure in certain instances is made effective through class action suits and stockholder pressure for expanded board representation and greater public disclosure.
- The judicial concepts of legal liability expand and the auditor's responsibility for fraud and deception becomes cloudy.
- The further development, standardization, and uniformity of techniques leads to questions re: "professionalism," in the sense that professionalism equals the ability to set one's own parameters for audit plans, procedures, and tests.
- Increased interest in the issuance of financial forecasts and the growing importance of interim reports raise questions about the need to assure the accuracy of those reports, thereby creating new responsibilities for the profession.
- The need to develop new audit techniques arises as the trend toward reporting current values develops.

Socio-Econo-Technological Influences on Auditing Evolution

Generalization of development by era is less than a totally satisfactory approach to history since it tends to obscure important cause-effect relationships. We can identify important events but we cannot say why the events occurred or measure their relative significance. By identifying the relevant social, economic and technological movements that have occurred during the last century it is possible to hypothesize a cause-effect relationship for these past developments and to improve our acumen at predicting future developments.

The Industrial Revolution. Certainly a dominant socio-economic movement in the last 200 years was the industrial revolution. The discovery of various means to create and harness mechanical power and the recognition of efficiencies possible from specialization of labor and consolidation of effort led to the modern industrial state. The revolution resulted in successively larger corporate entities and increasingly complex organizational structural forms, culminating in the existence of multi-national giants such as General Motors and

ITT, whose annual sales exceed the gross national product of all but a few of the larger nations of the world.

The aspect of the industrial revolution which had the greatest impact on the accounting profession was the growth in size of the business entity. Expanding corporations relied heavily on external credit, creating a vital need for expert independent professional attestation as to their financial condition. Expanding size meant also that all operations could not be under the direct control of a single manager, creating the need for a system of internal controls. Professional review of the adequacy of the controls fell to the independent auditor. Finally, as growth in size continued, the practical bounds of detailed checking were reached, and sampling procedures became the only realistic method of audit examination. The very genesis of the auditing profession and the source of two of the major audit "tools" (review of internal control and sampling) can be traced to the industrial revolution.

Public Ownership. A major consequence of the growth in size of companies was widespread public ownership of corporations. Expanding public investment in business in the early 1900's resulted in the separation of ownership and management and created the need for means of measuring the stewardship of management and providing large numbers of potential investors with information upon which investment decisions could be rationally based. The lack of uniformity and consistency in reporting methods and the need for independent certification of management's representations became a pressing issue as the large base of investors sought to evaluate the information being presented to them.

This new public voice and the persistent supplications of bankers caused increasing numbers of corporations to elect auditors and to have their statements certified in the years prior to 1929. However, there was little uniform agreement on just what audit objectives and procedures were or just what was being certified in a "certified statement." Many corporations simply stated that their records had been examined by certain auditors and neglected to mention the results of that examination. The efforts of the profession to develop uniform standards for reporting and for audit examination were drowned in the euphoria of investor speculation.

Regulatory Influence. The crash of 1929 brought into sharp focus the reporting abuses that had existed all along, but which had been tolerated or ignored. The influence of the stock exchanges, the emergence of the SEC and other regulatory agencies, and pressure from the investing public, encouraged the accounting profession to work in earnest to codify and enforce uniform rules of financial reporting and audit examination.

The Securities Act of 1933 and the Securities Exchange Act of 1934 are, of course, the foundation of the legislative structure that has been erected to establish the basic requirements of standardization of disclosure and mandatory audits. The SEC has steadily widened the extent of regulation through the periodic issuance of Accounting Series Releases, SEC Regulations, and the opinions of the Chief Accountant. The stock exchanges have amended their regulations to specify more rigorous requirements, and the courts have consistently expanded the scope and applicability of the original regulations. Thus, today's growing public pressure for more disclosure and greater uniformity in financial reporting is all the more effective because of this broader range of "tools" at its disposal.

Legal Environment. It was in the aftermath of the depression that the broader judicial view of individual and professional liability, which is continuing to develop, had its roots. The courts assumed a progressively more activist role toward all phases of society; they also reoriented their posture toward the business world from an attitude of "caveat emptor" to one of staunch defense of the rights of the public consumer of products and financial information. The courts progressively translated the ethical considerations of the past into the legal duties of today.

The reasons for this shift in judicial perspective can be traced in part to the increasing power and remoteness of business vis-a-vis private investors, and the desire to place the responsibility for the consequences of unfavorable events upon those who have the authority and ability to directly influence the events.

The impact of this judicial evolution has, of course, been a drastically expanded definition of the common-law liability of public accountants for injury to third parties. The concepts of limited liability established by Justice Cardozo in the *Ultramares* case in 1931 have been steadily broadened until the doctrines of privity, foreseeability and *scienter* were obscured. The *BarChris* decision in 1968 established the liability of auditors to third parties not "in privity" and the *Continental Vending* case (*U.S. vs. Simon*, 1969) punctured the shield of "generally accepted accounting principles" by requiring adherence to higher standards of fair presentation and informativeness.

Not only have the courts expanded the common law liability of accountants, but they have broadened and more rigorously enforced the existing regulations of the SEC and the stock exchanges. Of greatest impact have been the cases decided under SEC Rule 10b-5, which was originally intended to protect against fraud in the purchase as well as the sale of securities. Accountants' liability under this regulation was broadened by *Fisher vs. Kely* in 1967, where defenses of "absence of privity" and "lack of personal gain" were overruled and a requirement for more complete disclosure was established. The *Texas Gulf* case, also prosecuted under Rule 10b-5, expanded the spectre of liability by establishing that evidence of "wrongful purpose" was not a requirement of a 10b-5 violation.

The impact of this legal onslaught upon the sanctity of the auditor has been reflected in standardization and codification of audit procedures. Two cases in point were the promulgation of "Extensions of Auditing Procedures," which established the requirements for more rigorous receivables and inventories testing in 1939 following the *McKesson-Robbins* case, and the adoption of Statement on Auditing Procedure Number 41 which detailed the accountant's responsibility to report the discovery of facts subsequent to the completion of the audit, as the direct result of the *Fisher vs. Kely* decision.

Broader Social Changes. One can reasonably hypothesize that the legal trend described above is merely a reflection of the broader shift in the attitudes of society as a whole. One impact of an affluent society is to see a subordination of the drives for basic needs to the drives for love, acceptance, and self-actualization. The business world has lost its "mystique" and more and more people are concerned with the quality of life versus the quantity of goods, with the social cost of public goods, and with the social responsibility of business. Certainly the greater awareness and higher educational levels of the public have created

the demand for disclosure of matters previously considered to be privileged information and for greater professional responsibility.

One aspect of this greater social and public awareness is reflected in the accounting profession's desires to improve the quality of the financial representations produced for the public as well as the underlying audit support of that product. Liaison committees with the stock exchanges, the SEC and other regulatory agencies have been re-emphasized. The APB was formed to establish an authoritative professional doctrine that would serve to clarify and standardize corporate financial reporting so as to make it more meaningful for the public and more relevant for investment decision making. This increasing degree of professionalism (the assumption of responsibility for shaping one's own destiny and for responding to social needs) has been characteristic of the accounting profession recently.

Technological Change. Though the socio-economic trends have been the prime determinants of audit development, there is one technological influence that cannot be overlooked. The development of computers has drastically altered methods for data manipulation and allowed accomplishment of tasks of a magnitude previously unimagined, as well as accomplishment of routine tasks of previously infinite duration in a relatively short period of time. Since Univac I was introduced in 1951 we have progressed through three generations of computer sophistication and reached the stage where business simply cannot function without computer processing.

The transfer of much of business accounting data manipulation to computers may have improved the accuracy and speed of performance of simple clerical tasks, but it has added another dimension of the internal control problem: the computer programmer/operator complex; and it has in many cases made the audit trail much more difficult to follow. These factors have caused auditors to accelerate the development of corroborative and generalized evaluative techniques of auditing. The development of and increased reliance upon analytic review, statistical sampling, quantitative internal control evaluation, and comprehensive overall audit systems have been greatly accelerated by the computerization of business.

Summary

Our attempts to develop some reasonable structure for viewing audit milestones have tended to reinforce the assertions made earlier in the paper about the lack of orderly development of the profession. Auditing has not been characterized by a systematic and orderly development. It has not progressed down a well-defined path toward some predetermined goal. It has not, until recently, taken a strong professional responsibility for shaping change rather than responding to change. Much of the progress which can be identified has resulted from strong environmental influences, not the least of which has been the evolving regulatory and legal climate.

Unfortunately, many of these observations of the past seem to be still with us when assertions as to the future are made. Perhaps, due to the service nature of auditing, one cannot but expect a somewhat chaotic development, since the demand for and nature of work to be done is itself chaotic. Certain highly probable events on the horizon will tend to be professionally disruptive should

they occur. Three of the most prominent of these are (1) the trend toward "current value" measurements in financial reporting, (2) steps being taken toward increased publication of financial forecasts, and (3) increasing internal and external questioning of the scope and nature of traditional audit field work.

Current value reporting, in the sense of reporting valuations based upon existing market prices, replacement costs, or net realizable values, presents unique auditing problems of verifiability and testing. To the extent that many members of the accounting profession and investment community are advocating using current values for financial reporting, and to the extent that some progress has already been made in this direction, the auditing profession will face new requirements in planning and implementing the attest process.

With regard to publishing financial forecasts, a great deal of study is taking place within the professional societies in the accounting and financial communities, and many individuals are advocating formalization of such reporting. The SEC has already held hearings on publishing forecasts, and forecasts are now published in a variety of ways in the United States. In Great Britain and Holland financial forecasts are required to be published in some circumstances and certain audit responsibilities have been defined with respect to these forecasts. This attest responsibility has thus far been limited to an expression of an opinion with respect to whether or not the forecasts are consistent with the underlying assumptions used by management (and published with the forecasts) in making the forecasts themselves. Even if audit responsibility were so limited in the United States, new questions of liability and audit relationships between the various parties at interest would arise. In fact, it seems that tremendous conflict could occur if the auditor found that the rather mechanical forecasting calculations were in fact in accordance with the underlying assumptions, but that one or more of the assumptions themselves were questionable or fallacious.

A more subtle, and debatable, difficulty which we foresee arises more from a feeling and from conversations than from a discernible trend in the literature or in professional meetings. It seems to us that there is little basis for believing that the rather extensive audit testing that still occurs (even though the amount of detailed testing has been reduced) is justified when one looks at the types of difficulties which require a qualified opinion, a disclaimer, or extensive conversation between auditor and client prior to issuance of a clean opinion. Most reporting issues are exactly that, *issues*, arising from a measurement choice made by management from the alternative reporting possibilities available to them. In fact, most of these issues are known to both client and auditor and are not disclosed by "testing," in the usual sense. Other than for establishing precise cutoffs, audit testing tends to be defensive, wherein many tests performed cannot possibly lead to evidence that would cause the auditor to alter his opinion; indeed, many of the tests are apt to disclose internal control weaknesses or routine processing errors of concern to the management of a company but not to the shareholders. A possible exception would be disclosure of fraudulent transactions or events, where it is officially argued that the normal audit is not designed to, nor can it be relied upon, to disclose defalcations that do not materially affect the financial statements. As clients, outside investors, and auditors themselves push for higher quality work and better financial reporting, we feel that the entire audit process will be re-thought, including audit objectives and techniques.

Despite the rather critical evaluation which we have made of the manner in which audit progress has taken place, and the causation for that progress, we do have confidence that the profession will become an ever more constructive influence in the broad arena of financial reporting. However, such progress will not come in as orderly a manner as one would like, nor will the profession achieve its potential until it assumes an even more aggressive posture toward structuring its environment and itself, and until it does a more rigorous job of defining its goals and mapping the road to travel to attain those goals, including the measurable milestones.