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Discussant's Response to "Why the Auditing Standards on Evaluating Internal Control Needed to be Replaced"

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In a way, I feel that I should apologize for not joining Jerry and the AICPA Auditing Division leadership in supporting their response to the alleged expectations gap. One would like to support the profession that one studies and about which one teaches. However, it is traditional for a scholarly discussant to take a position contrary to that of the author. That will be easy for me to do since, as most of you know, I hold a contrary view on the need to replace AU 320.

It is also traditional to critically discuss a paper on the basis of its own criteria and to discuss the topic of the paper from an alternative perspective. I will follow the traditional approach, but in reverse order. I will begin by giving a little background on the role of Statements on Auditing Standards (SASs) in general, and the role and importance of AU 320 or Statement of Auditing Procedure (SAP) No. 54.

GAAS and SASs

As we all know, SASs are codified interpretations of Generally Accepted Auditing Standards (GAAS). They are quasi-legal in nature and help define acceptable practice under the securities acts as well as within the ethical rules of the profession. Codified professional standards play two important and related roles. They serve a before-the-fact *educational* role of guiding the auditor as to what should be done to conduct a "standard quality" audit under GAAS. They also serve an after-the-fact *enforcement* role in determining whether an auditor has been guilty of "malpractice." The first helps the profession by facilitating uniform, high quality audits and the second helps the profession by making it easier to disassociate itself from low quality audits. Thus, the SASs are important and they should be clearly worded and be readily interpretable.

Traditionally, SASs have related almost exclusively to the *effectiveness* of audits—that is, regulation to make sure that audits are effective in achieving appropriately low audit risk that error might exceed material limits. Some practitioners read the SASs as providing minimum requirements for a legal defense, and the minimum is their target. Without auditor quality differentiation, the SASs may also provide the maximum service in a competitive market. Therefore, it is important to have the effectiveness minimum clearly stated.

Efficiency, or the achievement of a given level of audit risk at minimum cost, has, with rare exception, been left unregulated or left without comment by the

Auditing Standards Board (ASB) for two reasons. First, in a competitive market, practitioners can be expected to be efficient on their own. Second, there is no long-run danger to the public of inefficient auditing—the market will discipline inefficient auditors.

SAP No. 54 (now AU 320) has had a revolutionary, and I believe salutary, effect on auditing practice, education, and research. Several generations of professors, textbook writers, students, and regulators have learned about the inherent limitations of internal control and the related necessity of substantive testing, the reasons behind segregation of duties, the *necessity* of compliance testing if controls are to be relied upon, the logical basis for evidence integration, and the basic concepts of control of audit risk. It has stood the test of time in practice and in research—many professors have tried to shoot holes in it and could not. Perhaps most important to us here, it gave a conceptual evidence model of auditing that has provided the basis for respect for auditing professors on campus. Many of us in this room are here due, in part, to SAP No. 54.

Certainly AU 320 is not perfect and it could use some updating and editing. In that regard, many of you are aware of my controversial letter of March 26, 1987 to Alan Winters. It was a response to his invitation to comment on the exposure draft (ED) of SAS No. 55. I read the ED with the view that, I believed, a skeptical, "minimum requirements-seeking" practitioner or accountant's defense attorney might take. Since AU 320 would be eliminated by the ED, I tried to read the ED without reliance on what I *knew* was in AU 320 because the next generation of students, auditors, and "enforcers" will have to read, understand, and apply SAS No. 55 cold!

In his response to the planning subcommittee (May 15, 1987), and the entire ASB (June 2, 1987), Al stated that there was little problem with the exposure draft but that I simply didn't read the words as he had meant them. The latter is true, of course. Both letters are in the public record if you wish to study the issues for yourself. I encourage you to try to read SAS No. 55 from the perspective of one who doesn't already know about AU 320.

I am pleased to say that I believe the current draft of SAS No. 55 is a considerable improvement over the exposure draft of last year. This is because, in effect, it *adds back* a number of the AU 320 concepts. Whether the present draft of SAS No. 55 is a net improvement over AU 320, or indeed, if the benefits of its passage outweigh its costs, is not at all clear to me.

The net benefits of SAS No. 55 are also not clear to others as evidenced by the fact that six ASB members had dissents or qualified assents to its issuance. Their number includes partners from five national accounting firms and the accounting professor, Jim Loebbecke. The audit firms are Ernst and Whinney, Grant Thornton, Laventhol & Horwath, Peat Marwick Main, and Price Waterhouse. Their stated concerns include illogical reasoning, confusing exposition that is likely to lead to over-reliance on controls, unnecessary changes of wording with no change in concept, and the need for stronger procedures to support the auditor's "understanding" of the control structure. That is, the dissenters are asking for *more* rigor as to effectiveness and *more* clarity!

This reception by a substantial minority of Board members can be contrasted with that of SAS No. 47 on Audit Risk and Materiality. SAS No. 47

was peculiar in that it added "structure" to the official literature, but its task force chairman (a Big-Eight partner and ASB member) wanted a 15-0 vote and held up a ballot draft until all objections by all parties were accommodated. A required 60% majority supported a more structured SAS but structure was diluted in order to get unanimity. For example, a requirement for "preliminary estimates" of materiality was replaced by the more vague "judgments about" materiality. Also, in an attempt to make the SAS "less quantitative in tone," the title was changed from "Materiality and Audit Risk" to "Audit Risk and Materiality."

SAS No. 55 is peculiar in that it is arguable whether it adds more structure than it removes. It is also peculiar in that its task force is the first to be chaired by a member of the AICPA staff. In contrast to SAS No. 47, the SAS No. 55 chairman apparently *did not* try to accommodate all suggestions for improvement. Ironically, if the chairman had achieved unanimity, then SAS No. 55 would have been a *stronger* document since the dissenters were asking for more guidance or clarity rather than less. In fairness to the task force chairman, political expediency may have necessitated foregoing further rigor and clarity.

SAS No. 55 and the "Expectations Gap"

Now, I'll discuss specifics of the Sullivan paper. I'll be very specific as to references so that you can verify my statements. On page 47, Jerry states that the nine new SASs were developed to "narrow what has been referred to as the 'expectations gap.'" Among the new standards is SAS No. 55 that "dramatically changes" the auditor's responsibility for considering internal control.

If we accept Jerry's premise, then we would reasonably expect to see the following in a discussion of "why" AU 320 needed to be replaced:

a. First, we would expect to see a description, listing, or citation of a number of highly visible audit failures due to the application of guidance in AU 320—that is, audits for which the auditor had properly applied the guidance and yet failed to detect material error.
b. Second, we would expect to see a focus in SAS No. 55 on audit effectiveness. The SAS would provide means of increasing audit *effectiveness* through guidance to prevent the abuses noted.
c. Third, we would *not* expect to see extensive discussion of *efficiency* or how to do an audit more cheaply or with less work since Dingell hasn't criticized the profession for being inefficient.

How well does Jerry's paper and SAS No. 55 meet these three expectations? First, let us consider the evidence on audit failures due to following AU 320.

On page 48, Jerry cites a "growing number" of practitioners who use preprinted memorandums proclaiming "no reliance on controls" yet rely on "effectively operating internal controls." We don't know if "growing" means from one to two or from 10,000 to 11,000 auditors, and Jerry doesn't claim that these audits were improper or ineffective.

On pages 48 and 49 he states that AU 320 and SAS No. 47 direct the auditor's attention toward internal control procedures related to account balances and transactions and not to the accounting system or control environment "which most practitioners believe reduce control risk." Now, if auditors don't rely on controls that they don't study or evaluate, then by not looking at the accounting system and control environment the audit may be inefficient. However, the audit would not necessarily be ineffective!

On pages 49 and 50, Jerry cites research conducted at Coopers and Lybrand. No reference is given so apparently this is secret research about which one can't determine the methods used, the data examined, or whether there were flaws in their application or alternative interpretations of the results. According to the secret C&L research [Sullivan, 1988, page 49] "the problem is not with specific internal control procedures; rather it is related to the *attitude, awareness* and *actions* of management related to financial reporting." [emphasis added]

Therefore, Jerry concludes that, we ought to audit management's attitude and awareness more and audit transactions and balances less. This is consistent with the views expressed in his 1984 Kansas paper [Sullivan, 1984] in which he championed reliance on supervisory controls verified by observation and inquiry over reliance on transaction and balance controls verified by reperformance.

The idea that, because few errors are discovered in tests of transactions and balances, we can deemphasize or even eliminate them is bothersome for two reasons. First, the auditor contracts to do an *audit*. The public *expects* that an auditor has audited transactions and balances, not just verified that management has a good attitude and awareness. Second, auditing behavior is dynamic or *strategic*—an analogy will suffice as explanation. There are very few guns detected at Kansas City International Airport. Yet, if gun control were reduced or eliminated, I believe that there would be many more guns leaving the jetway. Anticipation of detection yields prevention.

If the official audit literature is to emphasize management's good attitude and awareness as a basis for assessing low control risk, then I believe that the ASB should tell us *how much* the auditor can rely on management's general good "attitude and awareness" to reduce substantive testing across particular accounts and balances. Is it a lot? Can it be 100%? Or is it a very small amount?

There are repeated *efficiency* reminders in SAS No. 55. For example, paragraphs 31, 40-42, and 43-45 remind the auditor that results from testing one assertion for one account may be useful in reducing testing in another. Paragraph 48 and 50-52 give compliance tests as options for reliance. The auditor is also encouraged to rely on favorable audit results from last year [para. 23, 53]. It is not that the auditor should not consider such evidence, it is just peculiar that a document designed to increase audit *effectiveness* is directed at being *efficient* or, perhaps, the *ex post* legal protection of the auditor. There is only one warning and no examples that evidence from varied sources may conflict with or "disconfirm" each other. Such examples and warnings would likely increase effectiveness.

Finally, I'm very troubled by the suggestion, in paragraph 63, that the auditor try to figure out means of placing complete reliance on an assessment of low control risk. That is, the auditor would conduct no substantive tests for an assertion. The auditor is warned that "ordinarily" one cannot do this for all assertions on a significant account, but there is no guidance as to whether substantive testing should be the exception or whether complete reliance on controls is the exception. (It should be noted that the new SAS on Analytical Review reduces this risk.)

According to Sullivan [1988], SAS No. 55 provides a framework to improve control risk assessment in two respects:

1. It establishes a requirement to assess controls in relation to financial statement *assertions* (presumably all five assertions for each financial statement caption).
2. It replaces an "all or nothing," "rely or don't rely" approach with a more continuous approach such as percentages, or "maximum, moderate or minimum."

Now, does anyone really believe that we needed a new SAS to explain that AU 320 applies to assertions? I doubt it. Second, I cannot find any statement in AU 320 that dictates an "all or nothing" approach. In fact, paragraphs 72 and 73 of the original SAP No. 54 (now AU 320, 81-82) are explicit in discussing a *variable* extent of reliance and Appendix B [paragraph 35] illustrates reliance as being 30%, 50%, 70%, or 90%! That hardly sounds like all or nothing/rely or don't rely. Something is wrong here.

Overall, I'm not sure what is going on. There is a political problem for the profession. Is there an expectations gap (an effectiveness problem)? Is AU 320 part of it? Is SAS No. 55 more than the product of political-economic actions by the ASB?

As we have seen, if the Sullivan explanation is correct, there are some surprises in the data. There are no specific abuses listed nor locatable references to abuses. There is little, if any, increase in effectiveness of SAS No. 55 over AU 320 and there is a concentration on efficiency. None of those supports the claim that SAS No. 55 is needed to close the alleged expectations gap.

If you follow the ASB's activities, you know that the Sullivan paper is the fourth in a series of papers that "explain," "sell," or "excuse" SAS No. 55. One is by Dan Guy and Jerry Sullivan in the April, 1988 issue of *Journal of Accountancy* [Guy and Sullivan, 1988], a second is by ASB member Bob Temkin and Al Winters in the May, 1988 issue of *Journal of Accountancy* [Temkin and Winters, 1988], and a third will appear in the June, 1988 issue of *Journal of Accountancy* and will explain how one should apply SAS No. 55 to small firms. With an apparent lack of "effectiveness" differences from AU 320, these papers seem to be much like advertising for "new and improved" laundry soap.

Closing Statement

In his closing statement, Jerry states that Congressman Dingell has often asked how auditors can examine financial statements and not know about their clients' internal controls. Further, he states that the answer, "I didn't rely on internal controls" doesn't play very well.

I am very concerned that the answers given in SAS No. 55 won't play very well. That is, in defense of an audit failure, I would not like to hear:

"I didn't do much substantive testing because management had such a good attitude toward controls." or, "I didn't do much substantive testing because management had such a good system last year."

Now these responses seem silly to the uninitiated. But you, Jerry, and Al Winters, and Dan Guy, and anyone else who has reviewed the files know that such responses will be observed in future peer reviews and perhaps in court cases. I, for one, would be hard-pressed to say that the particular words in SAS No. 55 don't lend some support to that position.

References

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