Woman C.P.A.

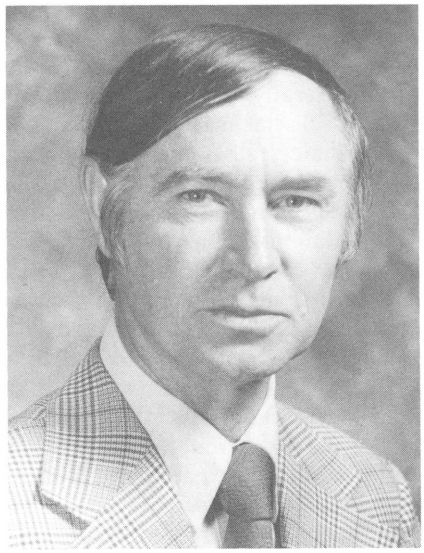
Volume 38 | Issue 4 Article 2

10-1976

Auditing Profession: Facing Up to Change

J. Herman Brasseaux

The Auditing Profession: Facing Up to Change



Dr. J. Herman Brasseaux, CPA
New Orleans, Louisiana

The author discusses the changing role of the auditor. This article is adapted from a speech given by the author at the Joint Annual Meeting of AWSCPA and ASWA in Houston, Texas in October 1975.

Dr. J. Herman Brasseaux, CPA, is Professor and Chairman of the Department of Accounting at the University of New Orleans. He holds a Ph.D. degree from Louisiana State University in Baton Rouge and a CPA Certificate from the State of Louisiana.

Dr. Brasseaux is co-author of The Auditor's Report *and* Readings in Auditing *and has published several articles on accounting. He is currently a member of the Auditing Standards Executive Committee of the AICPA; however, the views he expresses in this article are his and do not necessarily reflect those of the AICPA Committee.*

Change and the Profession

Change is a way of life and all institutions and professions, like individuals, have some difficulty coping with this phenomenon. The auditing profession finds itself in the midst of change and the challenges which have accompanied this period have been numerous and difficult.

We should not overlook the fact that the auditing profession shares the currents of change with the broad spectrum of service providers in our society. All groups, especially professional groups, which provide service are facing demands for change. The tendencies in the market which are characterized as "consumerism" have affected those who sell a service as well as those who sell a product.

Society's level of expectation for services has and is continuing to rise. Consumers (users) demand not only more services but also better quality services and are more discriminating in regard to services rendered. Additionally, there is a tendency for consumers to seek legal redress for services which are below expected standards.

To get a better perspective it might be advantageous to view the auditing profession as a subset of a larger service group which might be referred to as the "disclosure industry" or "information providers." This larger group has felt a public outcry for more information. This call for more disclosure is partly, but in this writer's opinion only partly, an aftermath of Watergate. Various groups in the disclosure industry are reexamining their roles. This is especially true of the Securities and Exchange Commission (SEC) which is reassessing its role in policing new demands for more disclosure from business to investors and the public. Auditors with their unique role in the disclosure process cannot hope to escape the dialogue and the consequences of change.

The current period of change will undoubtedly alter the boundaries of the profession. In fact it already has. The dimensions of the traditional role of auditing are changing and new types of services and new responsibilities are emerging. When we look back upon this period, i.e., the mid 60's to mid 70's, we will likely conclude that this was the most significant period for the auditing profession since the 30's and the era of McKesson Robbins.

Many leaders within the profession have observed that the expectation level for auditing services and the responsibility level of the auditor have risen at an unreasonable and alarming rate within the last few years. This kind of "future shock" pace, many feel, is on the verge of getting out of hand if it has not already done so.

Response to Change

There is a tendency among groups providing services to resist rapid fundamental change. This bias is generally well founded as society's basic "wants" change in a gradual fashion.

The auditing profession's bias against change — at least rapid basic change — is well anchored. This tendency is perhaps not an unlikely one for a profession whose service is still not widely understood or recognized by the general public. Some critics might suggest that historically the "personality type" atracted to auditing reinforces this tendency to avoid change.

It is abundantly clear, however, that the spirit of the times which has thrust the disclosure industry onto center stage compels a response on the part of the auditing profession. The profession is responding to demands for change — albeit sometimes reluctantly. It is widely recognized that the major catalysts contributing to the profession's response for change are the courts, regulatory agencies (especially the SEC), and the investing community. This has prompted the observation by some that the profession's role has been one of reacting rather than initiating action.

The primary professional body for defining the role of the independent auditor is the Auditing Standards Executive Committee of the American Institute of CPAs. This committee interprets auditing standards, sets guidelines for practice and reacts to calls for a broader scope of service and responsibility. The Committee functions largely as a synthesizer of policies and procedures in use in many major and some of the smaller auditing firms.

The Committee consists of twenty-one part time members, most of whom are auditing practitioners. During 1974-75, there was one member from a federal agency and one from academia. The Auditing Standards Division of the American Institute of CPAs provides the permanent staffing and research support for the Committee.[1] The Committee's official pronouncements are entitled *Statements on Auditing Standards.* These SAS's (twelve to date of this writing) are issued only after they have gone through an exposure period for comment from interested parties and have received at least a two-thirds affirmative vote by the Committee.[2]

Some Current Issues Receiving Attention

The number of SAS's being published belies the numerous issues under consideration in the profession and the volume of work carried on by the Committee and the Auditing Standards Division.

Recent SAS's

The Committee's output and pace of activity have steadily increased in recent years. During 1975 and through January of 1976, the Committee issued the following SAS's:

SAS No. 5
The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report (July, 1975)

SAS No. 6
Related Party Transactions (July, 1975)

SAS No. 7
Communications Between Predecessor and Successor Auditors (October, 1975)

SAS No. 8
Other Information in Documents Containing Audited Financial Statements (December, 1975)

SAS No. 9
The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination (December, 1975)

SAS No. 10
Limited Review of Interim Financial Information (December, 1975)

SAS No. 11
Using the Work of a Specialist (December, 1975)

SAS No. 12
Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments (January, 1976)

SAS No. 5 on "present fairly" was an attempt to deal with the extensive recent controversy regarding the real meaning of the auditor's report. The profession has been most concerned that the view advanced by some, including the courts, that "present fairly" means more than conformity with generally accepted accounting principles would force the CPA into an intolerable position and would impair the utility of the auditor's opinion. The SAS (1) defines "present fairly" within the context of generally accepted accounting principles, (2) establishes the need to consider substance rather than form in the application of accounting principles and (3) directs the auditor to consider whether the accounting principles used are appropriate in the circumstances. At the same time the SAS does not go very far in clarifying the auditor's responsibility for the financial statements and provides little guidance in the selection from among alternative accounting principles.

One of the most troublesome problem areas for auditors is that which is identified as "related party transactions." Financial statements may faithfully reflect transactions; however, if the transactions were "arranged" between parties on a less than arm's length basis, then the financial statements are false and misleading. The tasks of defining, discovering and disclosing related party transactions present the auditor with perhaps insurmountable difficulties. Extensive and heated debate ensued before a consensus was reached to publish some guidelines in the form of an SAS. The SAS puts all auditors on notice to be aware and suggests additional auditing procedures to help uncover manipulated transactions. The auditor's duty is to discover and understand the true nature of such transactions and insist that adequate disclosure be made in the financial statements. The auditor's ingenuity, integrity, and hard-nosed objectivity will be truly tested in applying this new SAS.

The SAS on "other information" breaks some new ground and deals with the auditor's concern with representations made by management in the annual report, other than the financial statements, which may be materially inconsistent with the audited financial statements or which may be material misstatements of fact. The auditors clearly do not audit any part of the annual report other than the financial statements. However, they now are expected to read the other information and take steps to remove significant inconsistencies or misstatements of fact which come to their attention. Thereby they are taking some added responsibility for the protection of investors and others.

One of the most controversial issues facing the profession concerns the need for and the nature of the auditor's involvement with interim financial information. Although the issue has been under consideration by the profession for several years, no one would deny that the SEC's action in this matter brought the issue to a head and precipitated action by the profession.

For some time, the SEC has called for auditor involvement with interim financial information on a less-than-audit basis. The majority of the profession has strongly opposed direct auditor association with interim financial data on a less-than-full audit basis. The profession has argued that the auditor's public association on a limited review type basis would provide an appearance of added credibility without adding substantive credibility. Also, there has been much concern about the increased liability risk which public association with interim financial information would introduce.

In 1975, the SEC issued Accounting Series Release No. 177 which requires the inclusion of interim income data as a "footnote" to the annual audited financial statements of most publicly traded firms. After strong objections were voiced, the Commission agreed to have the footnote marked *unaudited.* The auditor, however, is considered to be associated with such footnote information and is expected to make a limited review of the interim data, at least on a retrospective basis. In addition to requiring the footnote, the SEC Release *permits* (1) the registrant, in connection with filing its interim reports, to report that its auditors have made a timely review of its interim data, and (2) the auditors to file a letter stating that such a review has been made.

The Auditing Committee in December of 1975 issued SAS No. 10 on limited reviews. This SAS is the first of two SAS's expected to be issued on this matter. SAS No. 10 describes the new service, outlines the procedures which constitute a limited review and provides guidance and limits on the reporting. In this SAS the new service is directed to assisting the board of directors and mandates that the auditor's report on the limited review be restricted to the board and management of the client.

At the time of issuance of SAS No. 10 the Committee postponed the issue of public reporting, i.e., reporting to the SEC, stockholders and others. Since the SEC action in ASR No. 177 mandates public association of the auditor with the unaudited footnote data in the annual audited statements and permits association with interim (quarterly) data filed with the

SEC, the Committee is forced to face the question of public reporting and an exposure draft on this matter has been issued. The exposure draft on public reporting does permit the auditor to render a report based upon a limited review and permits this report to go to outside parties. The recommended format of the report uses very guarded language, but neverthelesss, it does represent providing some form of limited assurance on a review which is *less than* an audit.

The SAS on the audit inquiry letter to a client's lawyer (SAS No. 12) is significant in several respects. This issue created a major controversy — in fact, almost a confrontation — between the auditing and legal professions. A compromise was finally reached, but the SAS has brought to the surface a critical and sensitive issue, i.e., the duty to provide full disclosure in financial statements versus a firm's right to self-protection from the revelation of secrets and confidential dealings. The auditor is most concerned with full disclosure; the attorney with confidentiality. Unasserted claims became a pivotal question and the agreement in the SAS calls for the client's management rather than the attorney to provide that information to the auditor. The information provided to the auditor should be based on the client's and the attorney's interpretation of the requirements of generally accepted accounting principles, viz., Financial Accounting Standards Board Statement No. 5.

Other Current Issues

Great public concern has arisen regarding the responsibility for disclosing noncompliance with laws and regulations by business firms. Greater public sensitivity in the wake of Watergate and the disclosure of widespread illegal political contributions, bribes in foreign countries and others have been factors in creating pressure for action. The SEC and other regulatory bodies are reassessing their role and auditors, too, must reexamine basic assumptions and face up to their responsibility, if any, on this sticky issue. For the profession the question is: should the auditor in conducting an examination to determine the conformity of financial statements to generally accepted accounting principles be responsible to look for infractions of laws and regulations? Or, should the auditor report such infractions (only) if they come to his/her attention in the performance of an audit? Further, should the relationship, i.e., the proximity, of the effects of the infractions to the financial statements be the controlling factor? The issues are complex and far-reaching; however, it is likely that auditors will be expected to take some responsibility to deal with infractions which they uncover in the course of their audits.

The auditor's responsibility to detect errors and irregularities (frequently referred to as fraud) is also of widespread current concern although the issue has been around as long as auditing itself. In the aftermath of the wave of litigation against auditors from the mid 60's to the present and sensational scandals such as Equity Funding, loud demands for changes in auditors' responsibility for fraud have emanated from many quarters including the financial press. There are many misconceptions surrounding this issue including what auditors presently do concerning fraud, what the professional literature directs auditors to do, and what they should do and be held responsible for. The profession has been critized for the self-serving negative thrust of professional guidelines on responsibility for fraud in SAS No. 1. The debate in and out of the profession will undoubtedly result in a re-definition of the auditor's responsibility for fraud in more positive terms. The profession's final position on this question is not likely to satisfy all critics, however. Many outsiders feel that the subsequent discovery of undetected fraud is conclusive evidence of negligence by the auditor, whereas auditors maintain that some frauds may be so cleverly concealed, for example, through forgery or collusion, that assurance of detection through a normal audit is not feasible. The profession will likely declare that the discovery of fraud in financial statements is an objective of the audit examination while, at the same time, clearly holding that the audit is not a guarantee of the discovery of all frauds.

A Look at the Future

Many significant issues, in addition to those cited above, are currently being pondered by the profession and the future looks no less challenging. The increasing complexity of business operations along with society's continuing demand for greater accountability suggest that the auditor will be asked to assume a wider role and broader responsibilities. The profession should be prepared to consider a wider scope of service — after, of course, an appropriate weighing of all of the cost-benefit implications for society as well as the profession. Progress, in the form of a more effective audit role and in the form of new areas of service, must be our professional goal.

One significant attempt to be responsive to the current era of change has been the appointment recently of an Auditing Commission by the AICPA. This high-level Commission is examining the nature of auditing and the expectations of users of the audit function, considering the types (or degrees) of assurances which auditors do and should provide, and considering how professional standards might best be established. The Commission has a broad and optimistic agenda and will undoubtedly be a positive force in the profession's response to change.

The changes we now face and will face in the future affect all professional accountants, whether they be in public accounting or industry. The solutions will be more effective if all of us contribute our efforts to the task.

Notes

[1]For more information see: Hyman Muller, *Journal of Accountancy*, "The Auditing Standards Division: Responsibilities, Authority and Structure," September 1975, pp. 50-54.

[2]SAS No. 1, issued in 1973, is a codification of previous pronouncements, which were entitled Statements on Auditing Procedures.

[3]The procedures in SAS No. 10 constitute the appropriate procedures for reviewing the "unaudited" footnote as required by SEC regulations.