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AN INVESTIGATION OF THE CONCEPT OF MANAGEMENT AUDITING

BY

JOHN HERMAN SMITH
B.S.B.A., University of Missouri, 1960
A.M., University of Missouri, 1963

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R. K. Mautz
In Charge of Thesis

V. Van de Maris
Head of Department

Recommendation concurred in†

Norton M. Bedford
Carl T. Arlt
H. Peter Holzer
Paul M. Van Arsdell

Committee on Final Examination†

† Required for doctor's degree but not for master's

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CHAPTER I

PROBLEM AREA AND STUDY APPROACH

In a complex, industrial society such as exists in the United States, business or economic organizations play an important role. The economic structure of the United States consists of numerous organization units such as private business, non-profit organizations, and governmental units. One of the key factors in the control of these organizations is the communication of financial and economic information and one of the important factors for maintaining the accuracy and reliability of this information is auditing.

Auditing in some form is currently applied to almost all forms of expressed or implied representations. Management uses internal auditors to improve the reliability of internal reports and therefore to better control its operations. Owners and stockholders rely on external auditors to assure the reliability of management reports in order to better control the organization and the investment of their capital. Creditors and government agencies similarly use managements' reports for their decisions.

Whenever financial and economic information is communicated between two parties with dissimilar and often conflicting objectives, there is a question of its reliability. The basic audit function serves to improve the reliability of this information through an independent review of its accuracy. The external and internal audit of financial accounting, reports is well established; however, there is increasing interest in further development of broader audits. When information is communicated there is an expressed or implied representation of its accuracy, completeness, and, in business, implied assertions that resources have been utilized efficiently. This study is an investigation of one aspect of a broader concept of auditing; that of management auditing.

The General Problem and Need for Research in the Area

Two basic problem areas establish the need for this research; the first comes from the need for more and better information with which management performance can be evaluated and the second is the result of a need for more information about auditing so that its general nature, scope, and limitations can be better defined. Since World War II there have been increasing requests for some form of management audit and growing numbers of groups conducting examinations called management audits.

Factors Leading to Management Evaluation

Dewing has written that regardless of the reasons given, lack of success in business or any organization is always due to poor management.[1] While this has always been the case, some of the factors increasing the current interest in management evaluation are:

1. the increased size of organizations and the resultant decline in ownership control.

2. the increased competition among businesses due in part to improved technology in all areas of operation.

3. the increased public awareness of the effect of management

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[1] Arthur Stone Dewing, The Financial Policy of Corporations (fifth edition; New York: The Ronald Press Company, 1953), II, pp. 1216-17.

activities on the economy as a whole and on specific segments of the economy.

4. the increased willingness to apply some form of control to business operations to protect the public interest -- government controls.

5. the possible decline of the profit as the best measure of business success and best business objective.

In writing on the rise of "professional," self-perpetuating management, Ernest Dale expresses concern for the continuance of the traditional role of "partial proprietors" as restraints to help enforce proper management behavior. He suggests that the stockholder practice of selling stock when dissatisfied with company management permits the rise of self-perpetuating management. An independent review of management; that is, a management audit in the broadest sense, is suggested as a means of making management more accountable to stockholders. The only alternative may be government intervention,[2] which itself would be a form of management auditing.

A 1948 survey of financial analysts and bankers listed " . . . more information which will facilitate in appraisal of management. . ." as one of the principle things they wanted but which they were not getting in annual reports.[3] Recent suggestions by spokesmen for the Securities and Exchange Commission also indicate a need for more information by which to evaluate managements' activities. In relation to the need for

[2]Ernest Dale, "Management Must be Made Accountable," Harvard Business Review, v. 33 (March-April, 1960), pp. 52-59.

[3]Charles P. Rockwood, "The Changing Image of a Profession," The Journal of Accountancy, v. 110 (October, 1960), p. 41.

an improved concept of income which would reflect the utilization of resources controlled by management, Maurice Moonitz has written:

> If you tell me either that we cannot measure these things or that measurements are useless, then I answer that we are in the intolerable position of asserting that management is beyond control, that we cannot assess its performance with respect to the objectives of profitable employment of resources.[4]

The desire for better control over management activities is also evidenced by the numerous recent law suits against corporate officers for mismanagement.[5]

Limitations on the Reliability of Management Evaluation

Some of the factors that limit the effectiveness of management evaluation are:

1. a lack of clearly defined objectives for the utilization of resources by economic organizations.
2. a lack of clearly defined standards by which objective evaluation can be made.
3. the traditional confidential nature of information about managerial actions.
4. the inability of the general public to understand the problems and implications of such evaluation.

There is not sufficient agreement on the objectives of an organization's use of economic resources nor on the standards for good

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[4]Maurice Moonitz, "Should We Discard the Income Concept," The Accounting Review, v. 36 (April, 1962), p. 180.

[5]See for example:
Thor Power Tool Company law suit against former officers, Chicago Tribune, May 6, 1965. Stockholder law suit against Texas Gulf Sulphur Co.; Chicago Daily News, May 5, 1965.

management performance to make a completely objective evaluation. Without standards an evaluation may be nothing more than personal opinion which could vary with each examiner. Such evaluations are currently made by many financial analysts and are apparently inadequate. Some standards for management performance do exist and one problem is whether these are adequate for objective evaluation.

The confidential nature of most information about management performance is one of the most restrictive limitations on providing additional information of this type. Most modern management will not accept such reporting without some external pressure. Also there is a question of the ability of the general public to interpret such information if is made public. Stettler points out that reporting a management change in the annual report leads to misinterpretation and confusion for report readers because they have no way of judging the significance of the change nor why it was considered important enough to be reported.[6] It may be that management auditing will require more interpreting of the significance of information reported than exists in present financial auditing.

Recognition of Need for an Expanded Audit

Several authors have written about the need to expand the traditional external financial audit to provide more information. While there have been few changes in external auditing, these writers recognize the audit implications of the need for better information. Mautz and

[6]Howard F. Stettler, Auditing Principles (second edition, Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1961), pp. 556-557.

Sharaf raise the following question about the limits of auditing:

> Have auditors reached the limit of their services with the examination of the information in the traditional forms of financial statements and the expression of an opinion thereon? If the answer is in the affirmative, financial analysts must either rely on unverified data in arriving at investment judgements or find someone else to give them the same kind of assurance of reliability for such data that auditing presently gives to traditional financial statements. In either case the implications for auditing are unpleasant.[7]

It is possible that if some kinds of unaudited information are acceptable then unaudited financial statements might also become acceptable. However, it is also possible that financial analysts accept unaudited information only because there is no way now of getting such information verified.[8]

Internal auditors and governmental auditors do not limit their exaimation to financial statement related data and their activity in non-financial areas is in direct response to a need for more information about non-financial activities. Other services of the Certified Public Accountant may also be considered indications of the need for more than the traditional financial audit. The expansion of auditing into non-financial areas has also raised the question of whether all such activities are auditing and, if so, what are the characteristics that permit a given situation to be auditable. John L. Carey has written that the resolutions of the Committee on Long Range Planning of the American Institute of Certified

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[7] R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (Madison, Wisconsin: American Accounting Association, 1961), p. 180.

[8] Ibid., p. 188.

Public Accountants implicitly suggests that the attest function need not be confined to the conventional opinion on financial statements. A useful social service may be performed by attesting to various other types of data when the necessary conditions exist.[9] Bevis also suggests a possible expansion of the attest function; one area of this expansion may be in the direction of business planning.[10]

The Certified Public Accountant has expanded the scope of his service to management through increased emphasis upon internal control, operational audits, and management services. This study does not directly consider the audit by a Certified Public Accountant; however, the various services are considered in relationship to a broader concept of auditing which may ultimately be called "full service auditing" with the opinion on financial statements as only one of many audit results.

Objectives of the Study

There are several factors affecting the concept of management auditing, each of which is material enough for a research project such as this. The management audit concept includes too many variables to be adequately covered in one project. Some of the specific questions that can be isolated are:

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[9] John L. Carey (ed.), The Accounting Profession: Where Is It Headed (New York: American Institute of Certified Public Accountants, 1962), p. 62.

[10] Herman W. Bevis, "The CPA's Attest Function in Modern Society," The Journal of Accountancy, v. 113 (February, 1962), p. 34.

1. what are the basic functions of management in its current position in the economic community?

2. what management standards exist and may be used to evaluate management performance?

3. should the boundaries of accounting and auditing be extended to include management intentions?

4. what factors encourage or restrict opinions on management performance by Certified Public Accountants?

5. is management auditing the same as management counsulting?

Research has been conducted on each of the above problems with the primary or secondary objective of developing management auditing as a means of providing better information by which to evaluate management and control its performance. Some examples of the research previously conducted in this area are an investigation of the probable future of management auditing by the Certified Public Accountant,[11] a study and survey of the possible range of extended services by Certified Public Accountants,[12] an analysis of the theory and techniques used by management consultants in conducting "management audits,"[13] development of a theory of the corporate unit which might serve as a base for management

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[11] Edwin C. Bomeli, "The Audit of Management Performance," (Unpublished Doctor's dissertation, Michigan State University, 1963).

[12] John W. Buckley, "Extended Services of Professional Accountants: An Investigation of Management Services and Management Audit," (Unpublished Doctor's dissertation, University of Washington, 1964).

[13] George G. Miller, "A Critical Analysis and Appraisal of the Theory and Techniques of the Management Audit," (Unpublished Doctor's dissertation, University of Texas, Austin, 1959).

audits,[14] and investigation of the possible expansion of accounting to include more consideration of management's intentions.[15]

Assumptions Underlying This Study and Specific Objectives

The basic premise of this study is that there is a management audit concept underlying each of the above problems which is not limited to internal or external auditing. The two basic assumptions underlying this study are (1) that there is a general concept of auditing which includes both financial and management auditing and which transcends the definition of auditing assumed by any one practicing audit group, and (2) that there are identifiable features in current management audit practices which can be summarized to provide a basis for determining the requirements and limitations of successful management auditing. The subject is approached from an audit point of view which emphasizes the audit characteristics; requirements, and limitations.

The research and findings are not oriented toward any particular audit group as has been the case in most previous research in the area of management auditing. Contrary to Bomeli's findings that there are inadequate standards for effective management audits,[16] it is assumed that such auditing exists and that adequate criteria are available to

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[14] George C. Mead, "An Audited Public Report of Multiple Corporate Objectives," (Unpublished Doctor's dissertation, University of Illinois, 1962).

[15] A. Jay Hirsh, "Accounting for Managerial Intentions Underlying Plant and Equipment Investments," (Unpublished Doctor's dissertation, University of Illinois, 1962).

[16] Bomeli, *op. cit.*, p. 207.

evaluate management performance in some fashion. Some of the specific questions to be considered in this study are:

1. what is the broad concept of auditing which encompasses both financial and management auditing?

2. which of the audit groups considered are wholly or partly engaged in an activity consistent with the broad concept of auditing developed in this study?

3. what are the prerequisites for successful management audits and what is necessary for their attainment?

4. what are the current limitations on management auditing and what is necessary for their removal?

5. what criteria are currently used to evaluate management performance?

6. what audit group or audit type, if any, is best suited to conduct management audits at the present time and in the future?

These questions are answered by using material available in published literature and by analysis of the actual operations of some groups currently conducting management audits.

Organization of Research and Findings

The primary objective of the study is to organize, describe, and analyze the concept of management auditing as it currently exists to provide a basis for future developments. Littleton defines a concept as a mental pattern of related ideas which include recognition of what a thing is and is not.[17] The objective of this study is to investigate

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[17] A. C. Littleton, Structure of Accounting Theory (Madison, Wisconsin: American Accounting Association, 1953), p. 148.

some of these related ideas and to apply them to the subject of management audit.

The research and presentation is divided into two parts; the first part considers the general nature of auditing, management criticism and auditing, and the nature of judgment criteria; the second part describes and analyzes current practices of management auditing by some of the groups active in the area. Using the conceptual framework developed in the first part, each of the six previously established questions is considered.

The first part of the study considering the general nature of auditing and management auditing is presented in three chapters. Chapter II analyzes the nature of auditing by consideration of its historical trends of development, the current approaches to auditing, and some of the unresolved conflicts in audit practice. The emphasis is upon the development of a consistent, broader concept of auditing which is independent of accounting and traditional financial auditing. Chapter III is an analysis of the fundamentals of criticism in general and specifically management criticism. The nature of criticism and management criticism is integrated with the concept of auditing to provide a basis for the management auditing concept. Chapter IV investigates the nature of standards as used to interpret and evaluate evidence. The general categories of standards used in most professional endeavors are outlined for use in the analysis of audit practices in the second part of the study.

The second part of this study is an analysis and description of some major current management audit practices. The groups considered are: Chapter V, Internal Auditors and the Army Audit Agency; Chapter VI, the General Accounting Office, Chapter VII, Certified Public Accountants; and Chapter VIII, other external audit groups. Within the framework established in the first four chapters, the nature of audit service, the audit client, audit subject matter, and the criteria used to evaluate audit evidence are analyzed. The criteria used to form audit judgments are classified according to the outline established in Chapter IV. The apparent prerequisites and limitations of the successful application of management auditing are identified and summarized.

Chapter IX summarizes the research findings of Chapters V through VII and integrates these findings with the broad concept of auditing developed in the first part of the study. Answers to the questions identified on page 10 of this chapter are summarized and a conclusion is reached as to the audit group or audit type best suited to conduct management audits. The steps necessary for further development of management auditing and the most appropriate direction of future research are also summarized in Chapter IX.

Terminology Usage

No particularly new or unusual terminology is used in this study, but there is enough confusion about "common" terms to warrant explanation of the usage of some basic terms used throughout the study. The terms which refer to the activities of one specific audit group are explained as they are used in the appropriate chapter.

Audit

A broad definition of audit and auditing is used in this study. The exact definition is not established; however, basically the term is used to identify a specific, objective examination and evaluation of financial and economic plans, policies, procedures, actions, and reports. The problem exists that each reader tends to interpret audit differently depending upon his background. In this study the definition and usage of audit is not limited to the usage by any one audit group. One of the secondary assumptions of the study is that no one audit group should define audit only as it describes its activities.

Independence

Independence is one of the prerequisites of auditing in that the examination must be conducted by someone other than the original performer. The term "independent" is often used to describe financial audits by Certified Public Accountants, however, this usage is avoided in this study except in Chapter VII dealing specifically with activities of Certified Public Accountants. Generally in this study independence refers to the absence of responsibility for original performance of the audit subject.

Internal and External Auditing

These terms are used in the study to identify both the level of audit independence and the audit point of view. The terms are not used to distinguish a particular type of audit. Both financial and managerial auditing defined below may be conducted as either internal or external audits. Internal audits are those conducted by employees of the audited organization while external audits are conducted on a fee basis by individuals not employees of the audited organization. Both internal and external auditors may report to either management or outside interests since internal and external as used in this study merely identifies the audit point of view.

Financial and Management Audit

Financial audit is used in the study to describe audits which have the limited objective of evaluating financial report presentations. Management audits are those which evaluate management's plans, policies, procedures, activities, and reports whether in quantitative terms or not. In a general sense management auditing is inclusive and would include financial auditing, but for clarity in the study, management auditing and financial auditing are considered separate, and only the general term audit includes both. Management auditing also includes the terms operational auditing and comprehensive auditing as used by internal auditors and the General Accounting Office of the Federal Government.

CHAPTER II

THE NATURE OF AUDITING

The term "auditing" is used in many ways; yet, there seems to be agreement that there is a concept of auditing and, according to a recent American Accounting Association Monograph, a philosophy of auditing. Audit activities are conducted by many different groups and the scope of these activities varies considerably. The purpose of this chapter is to investigate the characteristics of auditing in terms of their development and existence in current audit practices.

An analysis of the general characteristics of auditing is a prerequisite to the investigation of the concept of management auditing, and this analysis furnishes the framework for determining whether the characteristics of management auditing are consistent with those of auditing in general. The basic assumption underlying this chapter is that no one group of auditors -- Certified Public Accountants, internal auditors, etc. -- can appropriately define all auditing by considering only its particular application of auditing, and that there is a broad concept of auditing which consistently applies to many different types of audit activity.

The approach used in the investigation of the nature of auditing is to begin with a brief review of the historical background of auditing. This review considers the stages of development, the reasons for each stage of development, and the type of audit activities involved. Particular emphasis is given to the historical antecedents of a broader approach to auditing than is usually found in writings about the historical development of public accountancy and audits of financial records. Following this review of audit history, current applications of auditing are considered and points of similarity or divergence are investigated. The general characteristics of auditing are then considered from the point of view of the audit methodology, and audit subject matter.

No specific definition of auditing is attempted; the objective is to summarize findings about the nature of auditing into a general description which is exact enough to identify auditing independently of the activities of any one audit group and is general enough to include present and future audit activities which are consistent with the audit characteristics described and analyzed in this study.

Historical Background of Auditing

As a service activity, auditing developed to fulfill some particular need and this section briefly reviews the needs giving rise to auditing and influencing the development of present-day auditing. The current nature of auditing is different from that of the past and this investigation provides insight into the background of present audit characteristics. Historical factors which provide a basis for a broader concept of auditing are of particular interest as justification for the inclusion of management auditing in a general concept of auditing. Three time periods are considered: auditing before 1800, auditing between 1800 and World War II, and auditing after World War II. The historical background of the relationship of auditing and accounting is also considered.

Development of Auditing Before 1800

Evidence of auditing can be found as far back in history as there are written records. Smith cites examples of auditing being used in ancient Egypt, in Rome before the fall of the Roman Empire, and at the time of Charlemagne after the fall of the Roman Empire. Auditing was also used in the Italian Republics during the Middle Ages and at that time auditors were in the same professional class as mathematicians.[1] These very early auditors served to improve the reliability of clerical activities and records. Management used auditors to control the work of other employees.

The use of auditing was accelerated during the time of English manors due to the size of the organization and division of responsibility present in the manorial system. The original meaning of the word "audit" comes from this period in which the accounts of a manor were publically read and heard by the people and representatives of the King. Littleton and Zimmerman state that the essence of audit action at that time was to examine, verify, and report and that these early audit actions, and the underlying beliefs, may also explain modern auditing.[2] Audits in Manorial times involved examinations of account records and

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[1] C. Aubrey Smith, Internal Audit Control (Austin, Texas: The University Co-operative Society, 1935), pp. 189-95.

[2] A. C. Littleton and V. K. Zimmerman, Accounting Theory: Continuity and Change (Englewood Cliffs, New Jersey: Prentice Hall Incorporated, 1962), p. 105.

preparing reports to absolve fiduciary responsibility. Verification applied to both the accuracy of the information reported and the completeness of the information included in the report.[3]

Littleton writes that there were two types of audits conducted in Manorial times. "In the first instance the necessities of the case seemed satisfied when the details of receipts were tested against common or public knowledge of what should have been collected and when detail payments reported against the receipts were made sufficiently public to reduce the temptation to fraud."[4] The audit action was a public reading of accounts and served the need for a means of evaluating the activities of people entrusted with resources. In the second type of audit, "the auditor apparently made up a combined statement of account from all other officers' books making sure of the correctness of addition, examining warrants for reasonableness in the meantime, and finally attesting to the subamounts and totals presented in a charge and discharge form."[5] Both types of audit were a check upon accountability for stewardship rather than profitability.

Manorial audits were a form of control over those in charge of resources and the subject matter of the audit was the account records of organization units. Account records were the only basis available to evaluate past activities and these records contained more than just financial information. Historians have reconstructed social, legal,

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[3]Ibid.

[4]A. C. Littleton, Accounting Evolution to 1900 (New York: American Institute Publishing Co., Inc., 1933), p. 264.

[5]Ibid.

and economic activities of manors from account records. As will be considered further later in this chapter, historically auditing applied to the best records available rather than to just accounting records in evaluating the propriety of activities and reliability of reports.

At the close of the Manorial period in England small private businesses developed and auditing was used less in business and more in government. Littleton writes that the auditory process in business in this period emphasized more scrutiny of written records and less evaluation of stewardship.[6] In government, stewardship and operation in the public interest continued to be the main audit objective. Some current government practices, such as publishing property assessments, can be directly traced to early English practices used to insure public control over the reasonableness of government operations.

Development of Auditing Between 1800 and World War II

The British Companies Acts of 1844 and 1862 were a significant factor in the development of one of the types of auditing developed several centuries earlier. Littleton gives the following description of the reasons audit requirements were included in these acts.

> In framing the companies acts, Parliament undoubtedly had public welfare in mind and the need to protect shareholders against fraudulent promotions and directors' mismanagement. To insure such protection would be a good public policy. Because knowledge of the usefulness of adequate and audited records had been transmitted from feudal days, it would have been surprising if provision for accounts and audits had been omitted from the companies acts when these were under development.[7]

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[6] Ibid, p. 265.
[7] A. C. Littleton, Essays on Accountancy (Urbana, Illinois:

These acts were an extension of the control function of auditing to aid stocholder control over joint stock companies. The laws specifically designated financial statement audits to the exclusion of the first type of manorial auditing in which audits provided a means of judging detail receipts and payments of those entrusted with funds. Management still feels it is necessary to give some report on its activities beyond that reflected on financial statements but these reports are currently without the benefit of audit. The professionalization of auditing which began in 1844 has continued and expanded. Littleton states that this is a natural consequence due to the need for independent check which lies deep in human nature.[8]

There is less written evidence about the development of other types of auditing during the period from 1800 to World War II, but the use of auditing to control government representatives continued and increased. One of the acts of the First Congress of the United States, in 1789, made a provision for an auditor whose duties were to receive and examine all public accounts.[9] This audit function continued to expand and was the forerunner of the current audit activities of the General Accounting Office in the Federal Government. Internal auditing as a means of controlling the activities of various levels within an organization, such as was the case in manorial audits, continued but

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University of Illinois Press, 1961), p. 96.

[8] _Ibid._, p. 97.

[9] Smith, _op. cit._, pp. 198-99.

did not attract as much interest as external auditing. Until shortly before World War II, activities of internal auditing were combined with management duties of control and evaluation and little was written about the development of a separate function.

Interrelationship of Auditing and Accounting

The British Companies Acts of the 1800's required audits of financial information which was the direct result of accounting effort. Up to the middle of the 1900's almost all auditing literature and auditing practice was directly related to accounting information. This close relationship is well characterized by the following passage from a 1911 book on accountancy:

> The accountant and auditor are often classed together and with reason. One in his own person usually discharges the functions of both, yet there is a difference. A man may be a good accountant and still cut a sorry figure as an auditor. He could scarcely be proficient as an auditor without a competent knowledge of accounts. The auditor is par excellence a critic.[10]

The simultaneous development of accounting and auditing has led to the traditional viewpoint that only a competent accountant can be a proficient auditor and that auditing is a part of the accounting discipline.

The interrelationship of accounting and auditing during the 1900's is further evidenced by the inclusion of auditing as one of the elements of a pattern of accounting in the American Accounting Association Monograph, Structure of Accounting Theory by A. C. Littleton. The sixth element in the pattern is "enterprise events and reports critically

[10]William Arthur Chase, Higher Accountancy (Chicago: LaSalle Extension University, 1911), p. 1.

reviewed."[11] Littleton stressed the fact that auditing was a means of doubling back to the starting point in the pattern and that an audit tests the mass of transaction facts which are compressed in financial statements.

The interrelationship of accounting and auditing seemed to reach a peak at about 1953, the time of the Littleton monograph. More recently auditor's duties have expanded to include activities other than those directly related to accounting systems and transaction data. In the same monograph Littleton relates auditing and accounting to social service because accounting is an information service but beyond that it has become in part a social instrument to make moral principles practical. "Obviously a moral obligation rests on accounting to produce figures and reports that will avoid deception as much as possible. The principles of accounting and procedures of auditing are directed toward that end."[12] It is possible that auditing and accounting developed simultaneously because social standards required only accounting report reliability as evidence of management's discharge of its responsibilities and as a means of controlling management's activities. As illustrated in Chapter I, there is an increasing demand for more and better information by which the public can evaluate and control management. Auditing developments since World War II reflect this changing requirement. Some accounting research effort has also been directed toward increasing the range of accounting to provide

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[11] A. C. Littleton, Structure of Accounting Theory (Madison, Wisconsin: American Accounting Association, 1953), pp. 116-17.

[12] Ibid., pp. 14-15.

more and better information.

Development of Auditing After World War II

In addition to the continued development and refinement of financial auditing after World War II, several different approaches to auditing began to attract increased interest and to be applied. External auditors began to emphasize their services as general business critics in areas other than financial reporting and external financial audits included more non-financial data as evidence supporting audit opinions. Auditing within the Federal Government expanded to include evaluation of management's actions as a means of attaining more effective control over resource usage.

During and after World War II, internal auditing became a more important tool for management control. The Institute of Internal Auditors was formed in 1941 to promote more efficient utilization and consistent application of internal auditing. The emphasis upon operational auditing by internal auditors is a continuation of the audit concept begun in early manorial auditing. In organizations, such as the early British manors and many present day corporations, some review of activities is needed for control. In the manor the auditor was to judge between the lord and his subordinates,[13] and in the modern corporation the internal auditor evaluates the activities of lower management and employees for the benefit of top management.[14] As in the manorial system, the best possible

[13] Littleton and Zimmerman, op. cit., p. 104.

[14] H. S. Arrowood, "The Modern Concept of Internal Auditing," The Internal Auditor, V. 20, No. 2 (Summer, 1963), pp. 12-24.

available information is used for the internal auditor's evaluation and report. The following section on current audit activities and the later chapters in this study consider recent management audit developments in more detail.

Summary of the Historical Development of Auditing

There appears to have been three distinct phases in the historical development of auditing. In the first phase, which reached its peak during the period of the English Manor system, auditing was primarily internal and emphasized improved management control over activities of an organization. These early audits included both an examination of the correctness of accounting records and an evaluation of the propriety of activities reflected in accounts. Auditing in this phase applied to all financial activities of management and served to improve report reliability as well as to evaluate management's decisions.

In the second phase of the historical development of auditing, financial statement audits of organizations issuing public reports were emphasized. During this phase of development the need for control over the use of resources was satisfied by the publication of reliable, fairly presented, financial statements.

The third phase of auditing development began after World War II and is currently being formed. Auditing is responding to the demand for more reliable information about management's activities than is present in financial statements. Some current audit activities provide a means of evaluating management activities such as was done six centuries ago. It is not within the scope of this study to investigate the reasons for the increased demand for better information with which to control and evaluate management; however, it may be due to either the increasing public responsibility assumed by business, a failure of accounting and financial statements to provide sufficient information, or both. The next section further analyzes the current concept of auditing as practiced by different audit groups.

Current Applications of Auditing

In this section the nature of auditing is analyzed by considering current audit practice as described in the literature. The audit groups used in this analysis are Certified Public Accountants, internal auditors, government auditors, and other groups using the term audit to describe their activities. Holmes suggests that the nature of external auditing by CPAs can be distinguished from other types of auditing by the objectives of the audit, type of audit work, areas covered by the audit, and degree of independence.[15] These four categories, including the qualifications of the auditor, are used here to describe the nature of auditing practiced by each group and to provide a basis for description of the general nature of auditing.

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[15] Arthur W. Holmes, Auditing Principles and Procedures (sixth Edition; Homewood, Illinois: Richard D. Irwin, Inc., 1964), p. 1.

Auditing by Certified Public Accountants

Individual state laws regulate public accountants and empower them to conduct audits leading to a professional opinion on financial reports. State laws do not specifically define an audit, nor establish what can or cannot be audited. The laws emphasize accounting skills rather than auditing skills and their main function is to provide criteria by which the quality of a public accountant can be evaluated. The American Institute of Certified Public Accountants requires that audits by its members be conducted in accordance with generally accepted auditing standards as defined by the Institute. The Institute establishes the pattern of audit practice by Certified Public Accountants even though it has only the power to revoke membership, not the license to practice auditing in a particular state.

Objectives of audits by Certified Public Accountants. The American Institute of Certified Public Accountants defines audit objectives as follows:

> The objective of the ordinary examination of financial statements by the independent public auditor is the expression of an opinion on the fairness with which they present financial position and results of operations. The auditors report is the medium through which he expresses his opinion or if circumstances require, disclaims an opinion.[16]

[16] Committee on Auditing Procedure, Auditing Standards and Procedures Statements on Auditing Procedure No. 33 (New York: American Institute of Certified Public Accountants, 1963), p. 9.

The Institute recognizes that this is a narrow definition applying only to the special responsibilities and functions of the external auditor when expressing an opinion on financial statements for the benefit of security holders and others. The different objectives of external auditors' examinations and internal auditors, which are considered later in this chapter, tend to complement rather than duplicate each other.[17]

Audits by Certified Public Accountants provide service by attesting to management's representations in financial statements. The audit objective is to provide service directly to outside interests by improving the reliability of the information communicated by financial statements and is primarily critical in nature since management and not the auditor is responsible for the statements. Much of the current literature on auditing practices points out the additional service to management that can be provided by auditors. This secondary objective, which can be referred to as integrated financial service, is becoming more important to the Certified Public Accountant.[18] Often no clear distinction is made between the objective of rendering an opinion on financial statements and the objective of providing service to management. Holmes distinguishes the two by stating that the principle purpose of an audit is to report independently on financial position and results of operations, however, an important corollary to this principle purpose is to act as an advisor to

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[17] Committee on Bank Accounting and Auditing, "Statement in Quotes," The Journal of Accountancy, V. 118, No. 6 (December, 1964), p. 60.

[18] Robert Beyer, "Integrated Financial Services," The Journal of Accountancy, V. 115, No. 6, (June, 1963), pp. 30-33.

and representative of owners and management.[19]

Type of audit work by Certified Public Accountants. According to a current auditing textbook, "... auditing is concerned with the verification of accounting data, with determining the accuracy and reliability of accounting statements and reports."[20] Auditing is primarily critical in nature rather than constructive and the essence of auditing is verification. Auditing techniques may vary in detail rather than in principle and the principle activity is examining and evaluating evidence to permit the auditor to form an opinion on the fair presentation of financial statements.[21] External auditors use various techniques and procedures to verify financial statements and their underlying records and most of them apply directly to data supporting financial statements.

A different emphasis in audit work is suggested by Carl Tietzen who describes the business approach to auditing as follows:

> It (the business approach) involves, among other things, an understanding of the company, its product, operations, problems and peculiarities, a knowledge of the industry and the company's place therein and familiarity with the capabilities of management. . . . obviously such knowledge enables the auditor to express a more informed opinion on the financial statements.[22]

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[19] Holmes, op. cit., p. 1-3.

[20] R. K. Mautz, Fundamentals of Auditing (second edition; New York: John Wiley & Sons, Inc., 1964), p. 1.

[21] James J. Mahon, "Some Observations on World Accounting," The Journal of Accountancy, V. 119, No. 1 (January, 1965), pp. 33-34.

[22] Carl Tietzen, "Changes in Public Accounting," The Journal of Accountancy, V. 105, No. 5 (May, 1958), p. 87.

Rather than a change in the nature of auditing, the business approach is a new audit technique which enables the auditor to more effectively accomplish his major objective of an opinion on financial statements as well as in the secondary service of assisting clients by making helpful suggestions.[23]

E. L. Kohler summarizes what seems to be the most acceptable description of the type of audit work done by Certified Public Accountants. "An annual audit may be defined as an exploratory, critical review by a public accountant of the underlying internal controls and accounting records of a business enterprise..."[24] This review which is essentially the collection and evaluation of evidence will be further analyzed later in this chapter.

Areas covered in audits by Certified Public Accountants. The basic subject matter of audits by Certified Public Accountants is financial statements prepared and published by management. The objective of an opinion upon fair presentation of these statements establishes this subject matter. However, in reaching this opinion, almost all areas of internal or external information serve as a source of evidence in the audit. Holmes' description of the audit areas is typical of that found in most literature dealing with external audits.

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[23] Ibid., p. 86.

[24] E. L. Kohler, Auditing: An Introduction to the Work of the Public Accountant (Englewood Cliffs, New Jersey: Prentice Hall, Inc., 1947), pp. 7-8.

> In his examination of the financial statements of a client, an auditor relies upon the examination of internal controls, statements, records, transactions and their underlying evidences for authority and validity, and evidence obtained from outside sources....[25]

The business approach to auditing advocated by Tietzen does not indicate a change in the areas considered by the auditor as much as an inclusion of more evidence obtained about the general quality of management performance to supplement evidence obtained from more traditional sources. Financial records and documents are the primary area of audit work by Certified Public Accountants, but no internal or external area is excluded from consideration.

Qualifications of Certified Public Accountants. The final factor in describing the nature of auditing by Certified Public Accountants -- auditor qualifications -- includes independence, knowledge of accounting, and compliance with generally accepted auditing standards. The generally accepted auditing standards established by the American Institute of Certified Public Accountants include general standards of independence, training, and due professional care; field work standards of planning, internal control review, and examination of sufficient competent evidence, and reporting standards.[26] These standards apply to the fulfillment of the basic objective of an opinion on financial statements.

Evidence of the importance attached to the generally accepted

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[25] Holmes, op. cit., p. 1.

[26] Committee on Auditing Procedures, op. cit., pp. 15-16.

auditing standards is found in a recent article criticizing layman audits of nonprofit organizations. John Reeves writes that an audit by unqualified laymen, not applying generally accepted auditing standards, is worse than no audit because it creates a false sense of security.[27] Another example of this point of view is found in a Journal of Accountancy editorial which reviews a 1960 ruling by a Chicago court. In this ruling the judge refused to accept testimony that an audit not complying with generally accepted auditing standards was not actually an audit. The editorial concludes that, unless care is taken to require audits conducted in accordance with generally accepted standards, the public may be grossly deceived.[28]

Summary of the nature of audits by Certified Public Accountants. The American Institute of Certified Public Accountants has established a rather definite description of the nature of auditing by public accountants which is generally followed by authors and practitioners in the field. The objective is attesting to third parties on management's representations in financial statements: the audit activities and subject matter involve examining financial statements and related data by collecting and evaluating evidence by which to judge their fair presentation; auditor qualifications are those established by generally accepted auditing standards.

Other approaches to external auditing, such as the business approach, use slightly different subject matter and techniques to attain

[27] John T. Reeve, "Audits of Nonprofit Organizations," The Journal of Accountancy, V. 119, No. 2 (February, 1959), p. 65.

[28] The Journal of Accountancy, V. 109, No. 5 (May, 1960), pp. 34-35.

the same objective. Other activities, such as management services and integrated financial services, are performed by the public accountant but are considered services over and above auditing. Management services by public accountants and their relationship to auditing are considered in more detail in Chapter VII of this study.

Auditing by Internal Auditors

Internal auditing is analyzed in detail in Chapter V in conjunction with the analysis of current management audit practices. In this section the nature of internal auditing is summarized for comparison with other audit activities and for development of a general concept of audit. The previous format of objectives, type of activity, area covered, and qualifications of auditors is used in this summary. Internal auditing developed as a tool for management control within an organization and has not, as yet, attained the professional level of its external counterpart. The duties and responsibilities of internal auditors vary in each organization, therefore, it is difficult to determine the exact nature of auditing practiced.

While there is much diversity in internal audit practice, there is some uniformity in the pronouncements of the Institute of Internal Auditors. These pronouncements are general recommendations only and the Institute does not have the authority to enforce its recommendations. The Institute's views on the nature of internal auditing are not consistent with all auditing practices, but its pronouncements indicate what its members believe constitutes good internal auditing.

Objectives of audits by Internal Auditors. The Institute of Internal Auditors describes the internal audit function as one of management control. Internal auditing is a control function that is concerned with examination and appraisal of other controls.[29] The overall objective of internal auditing is to assist all levels of management in the effective discharge of their responsibilities. This overall objective is divided into two distinct categories: (1) protection of the business -- are the assets on hand, are the reports correct, are prescribed procedures being followed, etc.; and (2) constructive appraisal of operations-- are prescribed procedures adequate, do reports convey a true picture to management, are prescribed policies and procedures adequate and effective, etc.[30]

In comparison of the objectives of internal auditing and external auditing, there are several points of difference and similarity. Major differences are: (1) internal auditors have no uniform end product or opinion, upon which they stake their reputation;[31] (2) internal auditors' work is for the benefit of management only, rather than outside interests; and (3) internal auditors consider constructive advice to management to be a primary objective and a basic part of the audit. Important

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[29] The Field of Internal Auditing (New York: The Institute of Internal Auditors, 1963), p. 1.

[30] The Institute of Internal Auditors (New York: The Institute of Internal Auditors, 1962), pp. 5-6.

[31] Cedric C. Slain, "Internal Auditing and the World Economy," The Internal Auditor, V. 19, No. 4 (Winter, 1962), p. 12.

similarities are: (1) the objective of both groups is a report on some aspect of business operations; (2) both groups serve as a means of improving control over business operations, the internal auditor for management control and the external auditor for control by outside parties. Internal auditors consider constructive recommendations to be an integral part of auditing which is a broader objective than in auditing by public accountants, but not a conflicting objective.

Type of audit work by Internal Auditors. The Institute of Internal Auditors refers to internal audit activities as examination and appraisal and as measurement and evaluation. Internal auditing, like external auditing, is basically critical in nature, but obtains constructive results in the form of opinions and recommendations. Most authors suggest that the internal auditor not take part in the accounting for operations since this lessens his value as an auditor. Internal audit activities include all of the audit work in the financial audit as conducted by the independent auditor, as well as activities that go beyond financial auditing. The audit manager of a large manufacturing concern suggests three activities over and above financial auditing which are typical of the work done; (1) determining whether operating executives are adequately informed on the progress of their plans, (2) determining whether established policies are complied with and whether these policies are deficient in anyway, and (3) determining whether management has the means of appraising the performance of people to whom responsibility and authority have been delegated.[32]

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[32] Ibid., p. 11.

The approach to collection and evaluation of audit evidence in internal auditing is little different from that of external auditing. Recent developments have extended the scope of internal auditing but have not changed the basic audit work which is a critical review and report based upon an examination of evidence dealing with expressed or implied management representations. The implications of the distinction between expressed and implied representations for the nature of auditing are considered further in later sections of this chapter.

<u>Areas covered in audits by Internal Auditors</u>. Since internal auditing is considered an arm of management and the internal auditor is an employee of the organization audited, the area covered by internal audits is whatever management requires.[33] Internal audits verify internal financial data and question operations for the benefit of management. Major policies and procedures as developed by top management are normally accepted as criteria by which operating policies, procedures, and activities are evaluated. The subject matter for internal audits is usually a segment of an organization rather than the organization as a whole. Current literature on internal auditing indicates the subject matter can be any area of an organization in which examination, analysis, and reporting are helpful to management;[34] however, most current practice emphasizes the accuracy and reliability of financial data and reports.

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[33] *Ibid.*, p. 8.

[34] Arrowood, *op. cit.*, pp. 12-24.

Qualifications of Internal Auditors. No national organization has the authority to establish minimum qualifications for internal auditors who, in the final analysis, must satisfy the management that employs them. There are two approaches used in current practice to establish the general qualifications for internal auditors. The first approach requires that the auditor have a good background knowledge of accounting and auditing techniques. From this background the auditor can develop familarity with the techniques of operations analysis. The second approach used is to train individuals already skilled in operations so that appropriate audit techniques can be applied to the review of operations. In this approach the auditor does not need a background in accounting to apply audit techniques. It is more important that the auditor thoroughly understand the objectives and functioning of his company.[35] Public accounting firms are currently using both approaches to develop their management services staff; however, external auditing requires a background in accounting.

The level of independence of internal auditors varies and the internal auditor is never independent of his employer. However, the internal auditor is usually independent of the particular area being audited. Organizational independence is important for obtaining meaningful audit results. The same basic requirements apply to external auditors who, by a broader audit responsibility, need more independence. E. B. Murray writes that although the internal auditor is management oriented, he must be organizationally independent of the business component he examines

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[35] Ibid.

and have a virtually unrestricted access to relevant information.[36]

Auditing by the General Accounting Office

Government auditors are a part of the broad category of internal auditors in that they audit government activities and report to some level of government. Their duties are limited to auditing activities of interest to the government and those in which they can be of service to the government. Current practices of the General Accounting Office are considered separately in the development of the nature of current auditing because the organizational characteristics of the Federal Government are different from those of private business, and because government auditors constitute an audit group which is highly organized and applies internal auditing uniformly. The approach used in this analysis is to consider the audit objectives, type of audit work, areas sudited, and general qualifications as compared to internal auditors in general. A more detail analysis of operational audits by governmental auditors is presented in Chapter VI.

Audit objectives and areas covered in audits by the General Accounting Office. The General Accounting Office is an agency of the legislative branch of the Federal Government whose duties include auditing government accounts and operations. The audit function includes both financial audits of Federally Chartered Corporations and more

[36] E. B. Murray, "Invitation to Progress," The Internal Auditor (Spring, 1964), p. 9.

comprehensive audits of almost all Federal Agencies.[37] The nature of the financial audits is the same as those of the Certified Public Accountants in that the American Institute of Certified Public Accountants' pronouncements are followed and that these financial audits may be performed by either the General Accounting Office or public accounting firms. Objectives of comprehensive audits are described by the following statement:

> Stated as simply as possible, the purpose of the comprehensive audit is to determine how well the agency or activity under audit has discharged its financial responsibilities. Financial responsibilities in this case are construed as including the expenditure of funds and the utilization of property and personnel in the furtherance only of authorized programs or activities and the conduct of programs or activities in an effective, efficient and economical manner.[38]

The objectives and areas covered in these comprehensive audits include the efficient conduct of only authorized activities, whether programs serve their intended purpose, whether expenditures comply with laws and regulations, whether assets are adequately safeguarded and efficiently used, and whether reports provide a proper basis for evaluating operations.[39]

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[37] Ellsworth H. Morse, Jr., "The Case for Accepting GAO Experience," The Journal of Accountancy, V. 109, No. 6 (June, 1960), pp. 61-64.

[38] United States General Accounting Office, U. S. General Accounting Office (Washington: U.S. Government Printing Office, 1954), p. 1.

[39] United States General Accounting Office, Accounting and Auditing Developments in the United States General Accounting Office (Washington: U.S. Government Printing Office, 1954), p. 1.

The comprehensive audits are intended to result in reports to Congress on how well Federal Agencies discharge their duties and the approach used emphasizes the potential available in making recommendations for improvement. The audit objective or recommendation for improvement includes both recommendations to Congress and the audited agency. The nature of auditing objectives and areas covered by the General Accounting Office is similar to that of most internal auditors because reports to top management on existing conditions and recommendations for improvement are the final result and findings can come from almost any area of operations.

Type of audit activity and auditor qualifications in the General Accounting Office. The basic audit approach and qualifications of auditors in the GAO are patterned after those of the Certified Public Accountant. Many government auditors are Certified Public Accountants and there is some effort to have audit experience with the General Accounting Office accepted as meeting the experience requirement for the CPA. In an article on this topic, Morse writes that the characteristics of the government auditor are the same as those of Certified Public Accountants except that the government auditor can and often does go beyond the normal financial audit. The audit standards of the public accountant apply as well as additional standards applicable to comprehensive audits.[40]

The major differences between government auditors and public

[40] Morse, op. cit., pp. 61-64.

accountants is in the scope of audit subject matter and degree of independence. Government audits go beyond the fair presentation of financial information and also consider nonstatement factors such as compliance and efficiency. Government auditors are not responsible to third parties directly and do not have to reconcile the interests of any party other than Congress.

Other Approaches to Auditing

The term audit is used in general business to describe functions within the accounting system of an organization. Titles such as "auditor of accounts payable" and "auditor of freight revenue" are often used. These are not true audit functions because they involve a vital link in the processing and summarizing of data, usually approval for further processing. They are functions with considerably different objectives, scope, activities, and qualifications than the audit groups previously considered.

Auditing is also used in general business as a description of some type of count or spot testing. For example, in marketing, terms such as "pantry audit" and "store audit" are used to describe the actual observation of a customer's pantry or a retail store's display shelves to determine products used or sold during a market survey period.[41] In this usage auditing involves testing and drawing conclusions thereon. While the technique is one used by the previously described audit groups, the objectives, subject matter, and qualifications differ.

[41]Robert Ferber and P. F. Verdoon, Research Methods in Economics and Business (New York: The Macmillan Company, 1962), pp. 20-21.

Another use of the term audit appears in the field of management consulting. The analysis of these activities and their relationship to management auditing appears in Chapters VII and VIII, and are not considered in depth here. The basic objectives, activities, subject matter, and auditor qualifications are similar to those of the audit groups considered here. These audits are most similar to those of internal auditors because the subject matter includes all economic activities, policies, and procedures of an organization, however, an external point of view is present. The objective is to report findings and recommendations to management. The audit activities of the American Institute of Management are also in this category.

Summary of Current Audit Applications

There are two general objectives of current audit practices, (1) to improve financial or economic operations of an organization by providing more and better information about these operations, and (2) to aid in the discharge of responsibility within an organization or between the organization and outside interests. The type of activity used to attain these objectives varies, but it is a critical rather than constructive activity. Audit activities are based upon the collection and evaluation of evidence from which management representations are evaluated and opinions formed. The representations can be either expressed, as in financial statements, or implied, as in the representation of skillful use of available resources. The subject matter of auditing is some form of identifiable organization or unit within an organization and audit techniques are applied to financial and economic plans, policies, procedures, activities, and reports of this unit.

Auditor qualifications vary but they consistently require at least a knowledge of the subject matter audited and a high degree of independence from the unit audited. The principle measure of an auditor's quality is his economic usefulness in improving control over the operations of an organization. Established audit standards provide a guide by which the public can evaluate auditors whose opinion is available to the general public. The remainder of this chapter considers the questions of audit methodology and subject matter in more detail.

Methodology of Auditing

In a recent American Accounting Association Monograph, Mautz and Sharaf recognize auditing as a specialized field of knowledge which is distinct from accounting and in which it is possible to develop a theory for testing present and future auditing practice.[42] One of the auditing characteristics considered in the monograph is audit methodology. This section relates the foundations of audit methodology in the monograph to those found in current activities by different audit groups.

Auditing is a form of critical analysis and is a dicipline in which judgment is required. Auditing uses an analytical approach and according to Mautz and Sharaf, the auditing approach includes:

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[42] R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (Madison, Wisconsin: American Accounting Association, 1961), pp. 13-17.

1. restriction of interest and inquiry primarily to matters on which judgment is requested.

2. adoption of a position of impartiality in formulating and expressing judgments.

3. basing judgment formation and expression on such evidence as is reasonably available.[43]

The above approach applies to the financial audit by external auditors, but it appears to apply equally well to audits of managerial actions, procedures, and policies. When the area of inquiry is adequately defined, the audit methodology can be applied.

Auditing judgment is based upon evidence and, unlike certain other fields such as law, the auditor must collect and develop the evidence, evaluate its adequacy, and form his judgment on the basis of the evidence. Judgment formulation in auditing is similar to the basic methodology used in all fields of scientific inquiry, but in auditing as in most practicing arts, a conclusion must be reached with less than conclusive evidence and past judgments cannot be reversed.[44] In the current audit practices previously described there is variation in the conclusiveness of evidence; however, this variability does not lessen the value of the auditing, it increases its importance as an art of evaluating evidence. Two possible levels of criticism and evaluation are considered further in Chapter III of this study.

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[43] Ibid., p. 22.

[44] Ibid., p. 23.

<u>Auditing Methodology for Problems of Fact and Problems of Value</u>

Mautz and Sharaf point out that the auditor must be concerned with problems of both fact and opinion. Financial statement facts such as the amount of cash, quantity of inventory, etc., must be considered and operating facts such as compliance with procedures and policies, compliance with laws, etc., should also be considered. Problems of value judgment in financial statements apply to the values assigned to items such as receivables and liabilities. In operations, value judgment must be applied to the appropriateness of policy, adequacy of records, and reasonableness of actions.

The auditing methodology for problems of fact is outlined as:

1. recognition of the composite problem
2. observation of facts relevant to the problem
3. subdivision of the composite problem into individual problems
4. determination of available evidence pertinent to the problems,
5. selection of applicable audit techniques, and development of appropriate procedures
6. performance of procedures to obtain evidence
7. evaluation of evidence
8. formulation of judgment.[45]

The auditing method for solving problems of value is outlined as:

1. recognition of the problem
2. statement of the problem
3. formulation of possible solutions
4. evaluation of possible solutions
5. formulation of judgment.[46]

Evidence is obtained in both of the above methods; although the nature of the evidence may vary. The evaluation of evidence may come from past

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[45] <u>Ibid.</u>, p. 27.

[46] <u>Ibid.</u>, p. 34.

experience, consequences of possible alternatives, and compatibility of alternatives with objectives.

The auditing methodology can be applied to a wide range of activities and its application can be to both the financial audit and the management audit. The major difference is that in a management audit most of the emphasis is upon value judgment which includes formulation and evaluation of possible solutions to a problem. The particular type of subject matter that can be the object of audit methods is the next consideration.

Subject Matter of Auditing

The characteristic of auditing to be considered here is developed by analyzing the types of problems that are appropriate for application of the audit methodology. The nature of auditing employed in this study and in most audit practice is best described by a combination of the characteristics of methodology and field of activity. As pointed out in the previous sections of this chapter, it is generally agreed that independence is imperative for auditing. The auditor may be skilled in many activities, but he must act exclusively as an auditor in any particular engagement to maintain appropriate independence.[47]

Most authors on the subject of auditing by Certified Public Accountants assume the basic subject matter to be financial statements of some economic organization, while internal and governmental auditors apply the methodology to all phases of operations including reports,

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[47] Ibid., p. 49.

statements, and activities. Other more narrow activities often termed auditing apply to a specific function within some organization such as in an audit of disbursements or a marketing audit. The subject matter of auditing chosen for use in this study is described here.

Auditing of Economic Organizations

The audit methodology does not apply to the activities of an individual, it is necessary to identify an organization unit which has clearly distinguishable internal and external interactions. The organization unit is audited from an economic point of view in almost all current practice and usually only events of economic significance are subject to audit. It is possible to use the criterion of "good for society" in reaching audit judgment; however, this criterion is best applied in auditing when it reflects the most appropriate economic action "for the good of society." The audit subject matter is an organization unit which has some external responsibilities for its actions. In the broadest sense an organization unit could be either one individual or a large multidivision business enterprise. Although an audit may consider noneconomic data, the collection and evaluation of these data is from an economic point of view.

Auditing of Activities and Representations

The two problems considered here are: (1) whether auditing is restricted to the examination of things such as financial reports or can be applied to activities as well, and (2) whether an explicit representation must be made before an activity or thing is auditable. The position taken in this study is that audit subject matter can be either activities, things, or reports summarizing activities. Audit methodology of collecting evidence, evaluating evidence and forming an opinion and recommendations thereon can be applied to specific items -- assets, reports, etc. -- as well as to activities leading to the existence of the specific item. One of the differences between financial auditing and management auditing is the relative emphasis upon reports in financial audits and activities in management audits.

The extent of the audit application to activities depends upon the representations involved. The major audit groups previously described consider both expressed and implied representations. Financial statement audits consider both the expressed representation of the physical existence as well as the implied representation of full, adequate disclosure. Operational audits and comprehensive audits place more emphasis upon implied representations such as efficient financial management of resources in accordance with the organizational objectives.

Various audit groups are more clearly distinguished by the difference in the extent of the implied representations used in audits than by the methodology employed. The objective of this section is to point out differences in the use of implied representations by audit groups rather than to propose boundaries for their use. Each audit group establishes the boundaries of the subject matter or representations it will consider and for maximum usefulness to audit report users these boundaries should be clearly defined and expressly stated.

Levels of Audit Application

Auditing is a control function which provides control over financial and economic plans, policies, procedures, actions, and reports of an organization unit. Three levels of control of organizations, and the applicability of auditing to each, are described here. The control levels considered are internal check, internal audit, and external audit.

Internal check is generally defined as a part of the internal control system of an organization. It is the feature of a data processing system which insures the proper supervision of recording duties, clerical proof, acknowledging performance, transferring responsibility, protective measures, and review.[48] Internal check activities incompass examination and review, but are also those activities which are an integral part of the operations of an information system. For this study internal check activities are defined as a part of operations of data accumulation rather than an audit function.

Internal and external audits are not an integral link in the operations of an organization. They serve the function of improving control over operations by an after the fact review and evaluation. Internal auditing improves managements' control over operations and external auditing improves outside interests' control over the operations of an organization. Both internal and external audits require an independence from the unit audited and a separation from performance of any operating duties.

[48] James B. Bower and Robert E. Schlosser, "Internal Control - Its True Nature," The Accounting Review, V. XL, No. 5 (April, 1965), p. 340.

Summary of the Nature of Auditing

The analysis of the current nature of auditing in this chapter is intended primarily to serve as a base for further analysis of current management auditing practices. The chapter emphasizes that which is consistent in current audit practice and develops a general pattern of auditing rather than a specific definition. The problem of describing the general nature of auditing is complicated by the fact that most authors and practitioners adopt a specific approach without clearly defining what they mean by auditing and without considering the applicability of their conclusions to auditing in general or as applied by some other auditing group.[49] This chapter establishes the general approach to auditing to be used in this study and the reasons for using this approach.

Historically both external and internal auditing have evolved from a common ancestry whose major reference point is the manor system in England. The objectives of current audit practiced that have evolved are to improve the quality of economic and financial representations of organizational units and to make recommendations for improvement whenever possible. These two objectives tend to compliment rather than conflict with each other.

General audit methodology is consistent in its use of evidence from which conclusions can be drawn, but the type of evidence used for these conclusions varies with the audit objective and the subject

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[49] Robert K. Mautz, "Discussion of Audit Recommendations and Management Auditing: A Case Study and Some Remarks," Empirical Research in Accounting: Selected Studies 1966 (Chicago: The Institute of Professional Acconting, 1967), pp. 152-155.

matter being audited. All current audit practice is based upon both judgments of fact and value; although, the relative emphasis varies.

The chapter develops the position that the audit methodology applies equally well to expressed representations, such as financial statements, and implied representations, such as reasonable utilization of financial resources. The general approach to auditing used in this study applies to both the audit of things, financial statements, and the audit of activities, compliance with prescribed policies and procedures. Auditing is limited to the examination of an economic unit which has distinguishable internal and external interactions. However, it is necessary that the audit function be separate from operations of the economic unit audited.

No universally applicable definition of auditing is developed; however, the general definition used in the balance of this study is that auditing is an examination, analysis, and appraisal of an organization's economic and financial plans, policies, procedures, actions, and reports. The examination is based upon the collection and evaluation of evidence and results in an opinion or recommendation for improvement.

CHAPTER III

THE NATURE OF MANAGEMENT AUDITING

Auditing is described in Chapter II as a particular type of examination of financial and economic information, policies, plans, or activities of an organization culminating in a report thereon. There are possible variations in the objectives of an audit and in the kinds of audit evidence that may be used. The purpose of this chapter is to identify that auditing which can be classified as management auditing; to relate management auditing to the general field of auditing; and to describe the nature of this management auditing. Auditing in general can also be described as a specialized, limited application of the art of criticism. Criticism is a much broader concept than audit since criticism can be applied to any subject matter; however, much current criticism is directed toward business organizations and the management of business organization. Since management criticism is a broader concept than management auditing and is practiced more commonly than auditing, a study of both general criticism and management criticism is helpful in developing a concept of management audit. In this chapter the specialized, limited audit applications of the art of management criticism are separated from general management criticism to better describe the nature of management auditing.

The first part of this chapter is a brief review of the general field of criticism emphasizing the alternative approaches and general characteristics of the art of criticism. Special attention is given to the specific characteristics of management criticism. In the latter part of this chapter the characteristics of management criticism are compared and contrasted with the characteristics of auditing described in Chapter II. From the comparison and combination of these two concepts, a concept of management auditing is developed which describes the management audits currently conducted and which describes management auditing as it is to be used in this study.

Nature of Criticism

Criticism is an activity common to all fields of endeavor and its validity and usefulness varies considerably within each field. Criticism is an art and critics are generally not inclined to specifically describe themselves or their work. The art of criticism has probably become more refined in the field of auditing than in any other field. The author of a 1911 accounting book wrote that "the auditor is par excellance a critic. His office is not so much to construct as to question."[1] It is not within the scope of this study to apply the logic of criticism and critical analysis to the entire field of auditing, although this would be a worthwhile project in the development of auditing theory.

For this study, the literature in criticism was briefly reviewed to determine a broad general approach to critical theory. An exhaustive study of critical theory was not attempted; therefore, the analytical

[1] William Arthur Chase, Higher Accountancy (Chicago: LaSalle Extension University, 1911), p. 1.

framework developed for this study may not be descriptive of all possible criticism. Although criticism is widely used, the development of general critical theory has, for the most part, been limited to the field of literary criticism. The literature reviewed for this study was primarily limited to applications of a general critical theory to literary criticism. From these applications of a general theory of critical analysis, a framework is developed for the investigation and description of management criticism.

Criticism Defined

Criticism is defined in Websters New Collegiate Dictionary as, "the art of judging with knowledge and propriety the beauties and faults of works of art or literature;" and a critic is defined as "one who expresses a reasoned opinion on any matter involving a judgment of its value, truth or righteousness or an appreciation of its beauty or technique."[2] This general definition emphasizes that criticism involves judgment. John Dewey has written that criticism is judgment which discriminates among values. Criticism identifies the better or the worse aspects of a subject matter and reveals why they are better or worse.[3] Shumaker writes that criticism is made up of analysis and evaluation and that the ultimate critical goal, whether attainable or not, is the "full, evaluated apprehension of the critical subject matter."[4]

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[2] Websters New Collegiate Dictionary (Springfield, Mass.: G & C Merriam Co., 1960, p. 47.

[3] John Dewey, Construction and Criticism (New York: Columbia University Press, 1930), p. 12.

[4] Wayne Shumaker, Elements of Critical Theory (Los Angeles: University of California Press, 1952), p. 13.

There are two basic types of criticism, both of which have considerable support in the field of literary criticism. One type is analysis which leads to description of the subject matter and the second type is analysis which leads to evaluation of the subject matter. There is no clear division between these two approaches and both require judgment by the critic. Historical descriptions describe a subject matter, but carried to the ideal extreme, they also include an analytical evaluation of the subject described. Descriptive criticism can be used to describe any or all forms of communication but it is the analytical and evaluative criticism based on logical analysis which forms the basis for most studies of critical theory.

Requirements for Logical Critical Analysis

In the theory of criticism, the usual approach to the critical process of analysis and evaluation is to set out three requirements for logical critical analysis. These requirements are: (1) a clearly stated purpose, (2) analytic procedures appropriate for the purpose, and (3) understandable and useful results.[5] This three-part approach is used in literary criticism; however, it is very similar to the description of auditing-- objective, methodology and report -- used in Chapter II.

Statement of purpose. A clear statement of the purpose of

[5] Ibid., pp. 31-32.

criticism requires the use of some frame of reference in the analysis and an indication of the frame of reference or standard being used. An approach often used in literary criticism is to make all evaluations clearly conditional and to include a description of the condition -- "if good poetry has a musical quality, then. . ." In auditing by CPAs the evaluative opinion is also conditioned by several factors -- "in accordance with generally accepted accounting principles. . ." The purpose of a critical analysis can be the evaluative criticism of a subject matter in general or it can be the evaluative criticism of limited aspects of a given subject matter. Usually as the critic expands the scope of his analysis, he becomes more subjective and the reliability of the criticism diminishes. However, the potential usefulness of critical analysis tends to increase as the scope of the analysis broadens. The scope of the analysis can be so broad as to be beyond human comprehension thereby reducing its reliability.

Appropriate analytical procedures. Appropriate analytical procedures for criticism should originate from the purpose. The logical, analytical methods chosen should fit the interests involved. One weakness in evaluative criticism of only limited aspects of a given subject matter is that there is a tendency to select those interests for which evaluation methods are available rather than those interests leading to the greatest understanding of the subject matter.[6] The frame of reference is important in selecting appropriate analytical procedures since

[6] Ibid., p. 64.

appraisal, evaluation, or judgment is based upon the relationship between a subject matter and a frame of reference or set of standards.

In a specific evaluative criticism, the use of appropriate procedures may involve both internal critical analysis and external critical analysis. Internal critical analysis is that analysis which is based only upon evidence found within the subject matter being criticized. External critical analysis is based upon evidence found outside the subject matter criticized and usually considers the general environment. For example, internal critical analysis by a theatrical critic would consider only the play itself, ignoring audience reaction, the playwrite, the social environment, etc. External critical analysis alone would consider audience reaction, etc. but ignore the play itself. Criticism based upon internal analysis tends to be more descriptive than evaluative since it is difficult to evaluate a subject without an external frame of reference. The choice of an appropriate frame of reference, internal or external analysis, and appropriate analytical procedures to be used to criticize a particular subject depends upon the subject and the purpose of the criticism and generally includes both internal and external information.

Understandable and useful reports. Understandable and useful results from logical critical analysis are probably the most important and the least developed requirement. Results can be stated in general terms by using adjectives such as: good, poor, fair, excellent, different, etc., or results can list specific findings with limited evaluative contribution. Results of logical critical analysis can be summarized in verbal reports or by a grading scale such as A, B, C, D and E. Grading of critical analysis is difficult and quite often impossible. Another approach to a clear, understandable report is to submit a cluster of properties to re-enforce a particular point of view and to avoid possible overemphasis on a single factor. Ideally a report should clearly set out the standards or frame of reference used for evaluation and should provide some rating or ranking of the subject matter evaluated. The validity of general broad criticism can usually only be determined by an investigation of the critic, his motives, background, etc. Specific analysis of smaller aspects of a subject matter, using a stated frame of reference, can be more useful. One author in the field of literary criticism shows his preference for specific analysis of smaller aspects by an analogy suggesting that a series of small torches lighting a path in the right direction is better than one huge bonfire at the start of a trail.[7]

The Nature of Management Criticism

Almost everyone criticizes the management of an organization at some time. Since management is the controlling factor in business organizations, any criticism of business actions or results of operations is an indirect criticism of management. Dewing aptly expresses this close relationship in the following statement about his book on corporate

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[7] *Ibid.*, p. 63.

financial policy:

> In a true sense the entire book is merely an exposition on a single thesis; it is the thesis that all questions of business resolve themselves into human elements grouped together under the broad caption of management.[8]

Dewing introduces his coverage of business failure by the following passage:

> These observations are merely preliminary to the statement that any discussion of business failure, whether we are concerned with the little enterprise or the large corporation, is to be prefaced by the broad generalization that failure is due to poor management, all else is excuse.[9]

By including all business criticism as indirect management criticism, there is an almost unlimited range of management criticism in existence. It can be tentatively stated that any auditing of business activities is, in a very limited sense, an audit of management since all questions of business resolve themselves under the broad caption of management. Current financial literature also contains much direct criticism of management in general as well as criticism of specific management policies and activities.

The characteristics of management criticism, like those of general criticism, can be classified in numerous ways depending upon the objectives and analytical procedures chosen for a particular critical evaluation. Some of the descriptive and classifying characteristics of general criticism that apply equally well to management criticism are:

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[8]Arthur Stone Dewing, The Financial Policy of Corporations (fifth edition; New York: The Ronald Press Company, 1953), II, pp. 1216-17.

[9]Ibid., p. 1217.

1. descriptive or evaluative criticism.

2. criticism of limited aspects or of a total subject matter.

3. criticism based upon an internal or external frame of reference.

Other characteristics that are more appropriate for only management criticism are the direct or indirect criticism discussed above and criticism based upon externally or internally available evidence. External evidence is that which is available to the public -- published data -- and the scope of evaluative criticism of management limited to published evidence would necessarily be limited. Management criticism based upon internal evidence would have access to all available evidence whether published or not. The choice of the type of evidence to be used may be beyond the control of the critic, but it can affect the reliability of his criticism.

The type of evidence -- internal or external -- is to be distinguished from the internal or external frame of reference for criticism. The frame of reference for management criticism can be either internal, relationships entirely within the organization, or external, relationship with external influences. As in the case of all criticism, the most useful results come from using an external frame of reference; although most criticism considers both.

The discussion of criticism up to this point has not provided a way of judging the quality of criticism in any given case. The literature in the field of literary criticism does not provide much criteria by which to judge the critic. The quality of any criticism is a product of:

(1) the critic's knowledge of the subject matter being criticized and (2) the critic's skill in the art of critical analysis. To further analyze the quality of management criticism, criticism is divided into two distinct types called "editorial criticism" and "investigative criticism."

Editorial Criticism

Editorial criticism of management of an organization is the result of forming a personal opinion which is either not supported by factual evidence or supported by limited factual evidence. Editorializing in the field of journalism is usually of this type in that the emphasis is upon the critical opinion rather than the supporting facts. Usually only limited reliance is placed on editorial criticism and the reputation of the critic is not always dependent upon the validity of his criticism. In editorial criticism the emphasis is upon the opinion instead of the evidence supporting the opinion. Most political criticism is also of this type since there is a tendency to play down factual evidence and emphasize personal opinion.

Editorial criticism serves a useful purpose by helping others to form an opinion on a particular subject matter; however, it is usually not reliable enough by itself to be persuasive to the reasonable and intelligent user. The quality of editorial criticism varies greatly depending upon the competence of the critic in the subject matter criticized and in the art of criticism. Even the highest quality of editorial criticism is limited in persuasiveness by the lack of objective factual evidence supporting the critical report. Criticism is seldom completely unsupported by factual evidence; therefore, there would be gradations in type between editorial criticism and investigative criticism discussed below.

Investigative Criticism

Investigative criticism of management of an organization is the result of the formation of a critical opinion based upon the examination and judgment of objective factual evidence. The emphasis is upon the collection and examination of supporting evidence. Although an opinion is formed, this opinion is based upon factual evidence. Criticisms of this type tend to cover much narrower topics than editorial criticisms since there is a limit to both time and finances in the collection and evaluation of evidence. Jury and judge verdicts reached in courts of law are investigative criticism since they emphasize judgment and opinion based upon factual evidence. A judge may find a defendant not guilty -- investigative criticism -- and still personally condemn the actions of the defendent -- editorial criticism.

In investigative criticism the reputation of the critic is directly dependent upon his skill in the collection of factual evidence, the evaluation of this evidence, and the formation of an opinion thereon. These critics tend to be more professional in the sense that the responsibility for their opinion goes beyond the ordinary laws of libel. The investigative critic is responsible for reasonable competence and care in the performance of his work; therefore, this criticism tends to be much more persuasive to the reasonable, intelligent user. The quality of investigative criticism varies widely depending upon the critic's skill in the art of criticism, knowledge about a subject matter, and collection of adequate factual evidence. As previously mentioned, most current management criticism is a combination of "editorial" and "investigative" criticism because it is partially supported by fact. However, in most current management, the poorly supported personal opinion seems more common than opinions based entirely on facts. Management consultants, management advisors, management service experts, etc. may perform investigative criticism when they are competent critics who are expert in the management field and when their reports are based on factual evidence. However, these "experts" are only a very small part of the broad range of management critics.

The investigation of the nature of criticism in general and management criticism specifically provides a framework within which the various types of criticism can be classified. It has been shown that criticism can be classified according to its purpose, procedures, or report. It has also been shown that variations in the quality level of criticism, the subject matter of criticism, and the evidence acceptable for critical analysis are almost unlimited. The next step in this study is to apply the description of auditing developed in Chapter II to the framework of management criticism established here to develop a definition and description of the concept of management auditing.

The Management Auditing Concept

The term management auditing, in its broadest sense, includes evaluation of management plans, policies, and activities, and reports on the results of management activities. It includes the terms "comprehensive audit" as used by the General Accounting Office "operational audit" as used by internal auditors and "management audit" as used by the American Institute of Management. In this broad sense management audit includes the "financial audit" conducted by CPAs since this audit is an indirect criticism of management. This inclusion is justified since all auditing is a specialized form of criticism and all criticism of business is at least indirect criticism of management; therefore, all business auditing is management auditing.

The concept of management audit described above is too broad for use in this study, however, its description illustrates some of the terminology problems that will arise in defining a narrower concept. Management audit as used in the remainder of this study will be limited to direct audits of managements' plans, policies, or activities. The results of operations or financial position of an organization may qualify as audit evidence for the management audit, but the normal "financial audit" by a CPA will not be classified as a management audit. Management audits are those direct criticisms of management which are consistent with the description of auditing presented in Chapter II.

Relationship of Management Criticism and Management Auditing

Management criticism can be either editorial, investigative, or some combination of the two. After management criticism has been separated by type, all types can be classified and described according to:

1. the user for which the criticism is intended.
2. the criticism of management in general or of specific management activities.
3. the use of internal or publicly available information.
4. the use of an internal or external frame of reference.

These four classifications of management criticism are now applied to management auditing.

Management criticism requires the preparation of a reasoned judgment or opinion about management plans, policies, and activities based upon analysis and evaluation. The three general requirements are: purpose, appropriate analytical procedures, and an understandable report. The procedures and the report are dependent upon the purpose of the criticism. Auditing needs a purpose, methodology, and identifiable subject matter as well as a formal or informal report. As in criticism, the methodology, subject matter, and report are dependent upon the audit purpose, <u>but,</u> auditing is currently defined and limited by the boundaries of its methodology and subject matter. The purpose of criticism therefore must be consistent within an acceptable range of methodology and subject matter to be described as auditing.

The basic ingredient of any audit examination is evidence, adequate, objective, factual evidence. Whether the audit is an examination of policies, activities, or information, it must be based on evidence and not mere personal opinion. The nature of investigative management criticism described previously fits this audit requirement whereas editorial management criticism does not. There can be editorial criticism of managements' policies, activities, or information but this should not be described as management auditing. Personal opinion, unsupported by factual evidence is not management auditing. The characteristics of management criticism considered in the following material will be those applicable to investigative management criticism.

Users of Management Audit Results

The intended user of the results of management criticism is not one of the primary factors in isolating that criticism which can be considered management auditing. While the reliability of criticism or audit may vary for different intended users, it is this variance in reliability and other factors which is the distinction between criticism and audit; not the intended user. Management criticism and management audit may be prepared for management itself, different levels within management, or for outside interests. Most current management auditing is conducted for service to management itself at some organization level. Management auditing by internal auditors serves management as a form of management control.[10] Management audits by the General Accounting Office lead to reports to agency heads, control agencies, or

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[10] The Institute of Internal Auditors (New York: The Institute of Internal Auditors, 1962), p. 5.

Congress.[11] There is no requirement in the current nature of auditing that audit reports go only to management or only to outside interests. Management criticism tends to be reported to outside interests as well as to management; and, if the demand existed, management audits could also be reported to outside interests. This point will be considered further later in this study.

Audits of Management in General or of Specific Management Activities

Management criticism may treat the organization management as a whole or treat only some specific part or activity of management. Critical theory indicates that a thorough analysis and evaluation of a limited aspect of a subject is more meaningful than a superficial examination of a broader subject, but this is not necessarily a restriction. Current management auditing tends to examine some limited aspect of an organization's management rather than overall management. Management audits by internal auditors include any phase of business operations in which an analysis and evaluation of policies and their application would be of service to management.[12] GAO auditors in the practice of management auditing also seem to treat smaller aspects in detail rather than evaluating overall agency management.[13] Other than a desire for more

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[11] United States General Accounting Office, Accounting and Auditing Developments in the United States General Accounting Office (Washington: U.S. Government Printing Office, 1957), pp. 3-4.

[12] H. S. Arrowood, "The Modern Concept of Internal Auditing," The Internal Auditor, V. 20, No. 2 (Summer, 1963), pp. 12-24.

[13] Ellsworth W. Morse, Jr., "GAO Audits of Management Performance," The Journal of Accountancy, V. 112, No. 4 (October, 1961), p. 43.

reliability, and possible economic limitations, there is no apparent reason why management audits cannot apply to overall management. This subject will also be investigated further later in this study.

<u>Management Audits Based upon Published Information or Internally Available Information</u>

Management criticism can be classified by the type of evidence used to evaluate management. Criticism can be based upon publicly available information or it can be based upon both internally available and publicly available evidence. Most current management criticism is based upon the analysis and evaluation of external, publicly available information. However, auditing as described in Chapter II cannot be limited by this kind of evidence availability. No existing, pertinent evidence should be unavailable to the auditor, and some required minimum of competent evidence must be collected or developed, analyzed, and objectively evaluated before management criticism can be defined as management auditing.

<u>The Frame of Reference of Management Audits</u>

Management criticism, as all criticism, must have a clearly stated frame of reference. This frame of reference establishes the criteria to be used in evaluating critical evidence collected or developed. Earlier in this chapter it was shown that it is almost impossible to obtain "good" criticism unless an external frame of reference -- set of criteria -- was used at least in part. This applies to management auditing as well.

Management auditing by internal auditors has been described as the review and appraisal of an organization's activities from the viewpoint of management.[14] Mangements' viewpoint is based upon internally available evidence and a combined internal and external frame of reference. The GAO's management audits are based upon internal evidence collected and developed at the agency level. This evidence is related to an internal frame of reference as well as the external objective of contributing to greater efficiency in government operations.[15]

The frame of reference of a particular criticism also helps to establish the boundaries of the subject matter to be criticially analyzed and evaluated. The possible subject matter of relevant management criticism is that of all features of the broad area of management. Any or all plans, policies, or activities of management are subject to criticism. Auditing, on the other hand, is limited to critical analysis and evaluation of financial and economic information, policies, and activities. Therefore, the subject matter of management auditing is limited to managements' plans, policies, and activities which are financially or economically significant. The criticism of any non-financial or non-economic activity would not be considered auditing. As described in Chapter II, auditing must be applied to a clearly distinguishable organization unit. This requirement differs somewhat

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[14] Frank Lennon, "Where are We Going as a Profession," <u>The Internal Auditor</u>, V. 20, No. 4 (Winter, 1963), p. 14.

[15] Ellsworth H. Morse, Jr., "The Case for Accepting GAO Experience," <u>The Journal of Accountancy</u>, V. 109, No. 6 (June, 1960), pp. 61-64.

from management criticism. General management criticism must have a frame of reference for the criticism but the critical analysis need not be applied only to the management of an identifiable organization unit.

Summary of the Concept of Management Audit

The concept developed and described here is that which is currently used and not an ideal notion of what the concept should be. The concept describes management audit practices found to be most consistent with the concept of auditing developed in Chapter II, and with the theory of management criticism developed in this chapter.

A management audit is an analytical examination of a management's financial and economic plans, policies, and activities. The examination leads to a report evaluating these plans, policies, and activities and recommending improvements where possible. The examination is performed by an auditor skilled in formal audit techniques and possessing knowledge of financial and economic operations of the organization audited. Audit evidence used is to be adequate, tangible, historical data which are objectively obtained.

Management auditing is limited to those management plans, policies, and activities of direct financial or economic significance, whereas management criticism is not so limited. Management auditing is limited to those examinations or criticisms of management in which sufficient, competent, tangible, and objective evidence is collected and evaluated by acceptable audit techniques and procedures. The adequacy of evidence and the collection and evaluation of evidence as it is used in auditing are not capable of being exactly defined. The criteria used to evaluate this evidence are also not capable of being exactly defined. The next step in this study is to review the nature of criteria used in various fields to judge evidence. Auditing must also be applied to some identifiable unit for which an appropriate internal and external frame of reference can be established as a basis for evidence collection, evaluation, and interpretation in the form of a useful report. This review is a prelude to the description of criteria used to judge evidence collected and evaluated in current management audits.

CHAPTER IV

THE NATURE OF STANDARDS AS JUDGMENT CRITERIA

The two preceding chapters emphasize the need for an auditing frame of reference which will isolate the subject matter to be audited, identify the evidence to be used in an audit, and describe the criteria by which audit evidence is to be analyzed. Chapter III describes the frame of reference, subject matter, and type of evidence needed for management audits. The later chapters of this study consider the criteria by which management audit evidence is currently judged. This chapter provides the background for the classification and description of criteria used in a management audit.

Since there are many types of standards in use today, it is not sufficient to state that there must be auditing standards or judgment criteria without more explanation of the nature of the standards being considered. At one extreme the international standards of weights and measures are of little use in auditing and at the other extreme the cultural standards of artistic taste cannot be used in auditing. In this study an investigation of standards in general is needed to be able to consider the advantages and the limitations of the type of standards used in auditing. The criteria currently used to evaluate management audit evidence must be consistent with the general characteristics of standards as judgment criteria.

The approach of this chapter is to consider the definitions and usages of standards in their broadest sense of cultural and environmental standards to determine what types of standards can be considered in an evaluative judgment. The general types of standards used as judgment criteria in fields other than management are briefly reviewed to develop descriptions of general categories of standards that are applicable to applied sciences. The next step is to isolate those criteria which are applicable to management audits. The nature of these standards is summarized and a classification scheme developed which will be useful in describing the criteria currently used in management auditing.

The Nature of Standards

It can be seen, after a brief review, that not all things termed standards can be the same; however, people seem to know intuitively what is meant by "professional standards," "standard time," "standard of living," "standard weights and measures," and "standardization." In a 1917 work on cultural, literary, and artistic tastes, W. C. Brownell wrote the following introduction to standards as a measure of value·

> It is perhaps a little difficult precisely to define the term "standards," but it is happily even more superfluous than difficult because everyone knows what it means.[1]

Brownell goes on to say that standards, "belong in the realm of sense rather than in that of reason and are felt as ideal exemplars for measurement by comparison, not deducted as criteria of absolute authority."[2] This leads Brownell to decide that standards are established

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[1] W. C. Brownell, Standards (New York: Charles Scribners' Sons, 1917), p. 1.

[2] Ibid.

mentally from an automatic sifting of experience rather than from direct reflection. Standards to him are products of culture rather than philosophy. This may explain some of the difficulty in expressing any ordered description of the nature of standards. The following description of the types of standards available for current use must be qualified from the start by the fact that many evaluative criteria are the result of subconscious comparisons with experiences -- feelings -- which are difficult if not impossible to describe and classify.

Definition of Standard -- Criterion

Webster's New Collegiate Dictionary lists twelve possible meanings of standard and four common synonyms. The most appropriate definitions for the purpose of this dissertation are:

> That which is set up and established by authority as a rule for the measure of quantity, weight, extent, value or quality. . . .
>
> That which is established by authority, custom, or general consent, as a model or example. . . .
>
> Standard applies to any definite rule, principle, or measure established by authority.[3]

The same dictionary defines criterion as:

> A means of judging. . . a standard of judgment; a rule or test by which anything is tried in forming a correct judgment respecting it.
>
> Criterion implies a measure or test of a thing's quality, such as goodness, beauty, etc.[4]

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[3] Webster's New Collegiate Dictionary (Springfield, Mass.: G. & C. Merriam Co., 1960), p. 825.

[4] Ibid., pp. 197 and 825.

Both standards and criteria apparently derive their usefulness from a comparison with subsequent facts. The above definitions seem to indicate that standards exist for any value that is communicable. Standards are "an agreed upon criteria of what is proper practice in a given situation; a basis for comparison."[5] Standards also may be specification or material standards, covering for example, length, area, and volume; mass, weight, density, and pressure; heat, light, electricity, and radioactivity. All standards serve as a basis for direct comparison, judgment, and indirect improvement through standardization.

Types of Standards Used

There is a wide range of standards in use in various fields of endeavor. Standards for modern art must be approximate and general whereas stadards of size in electronics must be very precise. One author has written that standards for modern art are so subjective that we must take the artist's word for his success.[6] On the other hand, standards of physical size, that are accurate to one part in a million, are maintained by the National Bureau of Standards.[7] The purpose of this section is to review the types of standards used as judgment criteria in order to obtain a background for the identification

[5] A. C. Littleton, Structure of Accounting Theory (Madison, Wisconsin: American Accounting Association, 1953), p. 143.

[6] Brownell, op. cit., pp. 127-128.

[7] John Perry, The Story of Standards (New York: Funk & Wagnalls Company, 1955), p. 192.

and classification of management audit criteria. This review of types of standards can be neither exhaustive nor in great depth for any one type of standard.

Measurement standards vs. computation standards. Standards can be developed for use in various forms of measurement or they can be developed for use in computations. Measurement standards provide a way of describing, comparing, or communicating features such as size, quality, speed, etc., of tangible or intangible objects or activities. Standards such as the meter for length, prime for meat quality, MPH for speed, and the pay-out ratio for common stock are measurement criteria. Standards of computation are rules for comparisons, combinations, and other calculations, which generally follow the criteria of mathematical logic.

The systems of measurement standards are usually not as precise nor as compatible as the systems of computational standards, however, the relationship between measurement and computation criteria becomes more important when a particular endeavor uses more computation. The more scientific a field of endeavor, the more computation is involved and the more important it is that measurement and computation standards are compatible.[8] Thus, the physical sciences tend to use metric standards of weight and size because they are more compatible with the decimal computation system. Criteria used in a management audit

[8] Ibid., pp. 80-83.

must be measurement standards applicable to various management plans, policies, and activities rather than computation standards. However, as management becomes more scientific, it is important that measurement criteria in management be compatible with the rules of computation. The development of mathematical measurements is an attempt to make measurement criteria compatible with computation rules.

Social standards vs. technical standards. An activity or object can be judged by social standards of morality, ethics, taste, etc., or it can be judged by technical standards of size, quality, practice, performance, etc. Social standards form the basis of civilized society, but except when formalized by law they are usually not precisely defined. Brownell describes social standards as those based on tradition and, as such, no one person can develop his own social standards.[9] Social standards deal primarily with people, their ideas and activities, therefore, no exact description is possible. Individuals or groups can define current social standards but it is practically impossible for an individual or group to establish social standards. Social sciences, such as philosophy, psychology, and theology, attempt to develop more exact measurement criteria in order to improve descriptions, comparisons, and judgments of social activities. Harrison's projection, made in 1928, that the day of the "arbitrary opinion" is passing and

[9] Brownell, op. cit., pp. 40-41.

that even "expert judgment" is becoming less desirable,[10] seems to be applicable today. Much effort is currently expended to obtain more exact definitions of social standards. Management in today's society has taken on certain social responsibilities and its plans, policies, and activities are subject to measurement by social criteria.

Technical standards are usually related to scientific processes in which precise and consistent measurements of physical characteristics, performances, or practices are possible. Most technical standards are clearly defined by rule or edict and any discrepancy is easy to discover. Perry describes the relationship of the evolution of technical standards and science as follows:

> Essentially, what happened is that measurement, once an art, became a science, and responsibility for standards passed from the hands of rulers into those of scientists.
>
> . . . .
>
> Standards and science are inseparable. The story of standards is the story of science itself. Not all science is measurement. Some of the most important discoveries were, at first qualitative observations, but when measurement was not the first step, it was the second, and through measurement most of the laws and axioms and principles of science have been formulated.[11]

Management has its technical standards of performance and practice -- scientific management -- but most of these criteria are less exact than those of the physical sciences. The structure of criteria by which management can be judged, which is developed later in this chapter,

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[10] Norman F. Harrison, Standards and Standardization (New York: McGraw-Hill Book Company, Inc., 1928), p. 216.

[11] Perry, op. cit., pp. 13-14.

will need to include both social standards and technical standards.

<u>Legal standards vs. standards of custom</u>. Some measurement standards are formalized by law whereas other standards are merely custom or trade practices. Laws provide social or technical criteria by which the measurement, description, and judgment of an object or activity can be accomplished. Most laws are exact, inflexible standards, but they can be subject to variable interpretation. Most laws exist for the protection of society; therefore, most legal standards are also social standards. Standards of custom or trade practice are usually less exactly defined than legal standards, but they cover many more measurement criteria. Trade associations and other similar organizations are very active in the establishment of standard measurements of objects and practices. The current social and economic environment of management has evolved from customs and some of these customs have been formalized as laws, but most have not. The development of a set of criteria by which management's plans, policies, and activities can be judged must consider both legal standards and standards established as custom without legal formalization.

<u>Object standards vs. activity standards</u>. The types of standards presented above all apply to the measurement of either activities or objects. Standards can also be classified according to their application to either physical objects or to activities. Harrison, for example, listed five types of industrial management standards, of which three --

measurements, constants, and quality -- apply to physical objects and two -- performance and practice -- apply to industrial management activities.[12] Standards as measurement criteria for physical objects tend to be precise and well defined. Often the allowable variation from standard is well established. Most object standards are technical criteria, but some social criteria such as public safety may be considered. Standards for the measurement and evaluation of activities can be social, technical, legal or customary. These criteria are usually less exact and less well defined than those of physical objects. Since activities usually involve the actions of people, the evaluative criteria must be more general and allow for a reasonable margin of error. Physical objects may be used as one way of evaluating the series of activities leading to this object; however, standards also are necessary for the direct evaluation of activities. In management auditing the standards must provide criteria by which management's activities as well as the objects of plans and policies can be evaluated.

Summary of the nature of standards. This brief review of the literature on the nature of social standards and industrial standards has shown agreement on one feature; that is, that standards are necessary for civilization to exist and that the more highly developed total society or any part of society becomes, the more important it is to have standards for communication, measurement, and evaluation.

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[12] Harrison, op. cit., p. 23.

Brownell pointed out that the more people and personalities are involved, the more difficult it is to develop meaningful standards.[13] However, whether uniform and well defined or not, these standards do exist. Another textbook is highly critical of standardization and urges a limit to the standardization of man, but, even with this warning, the necessity of some form of standards and standardization is recognized.[14] The familiar quotation that, "to understand something, one must be able to measure it," illustrates the point that even before any measurement can be made it must be decided what to measure; what is significant and how to isolate and evaluate significant qualities. Often the measurement action comes before the establishment of formal standards and leads to the development of formal standards.[15] Management seems to be currently in the process of developing measurements and formal standards to apply to its own activities and, in this development, management auditing can contribute to "management science."

Usage of Standards as Judgment Criteria

It has been shown that numerous standards are used in all fields of endeavor. Some standards are well defined and others are little more than approximations. It is impossible to list all available standards

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[13] Brownell, op. cit., pp. 130-134.

[14] F. R. Leavis and Denys Thompson, Culture and Environment (London: Chatto & Windus, 1948), p. 35.

[15] Perry, op. cit., p. 211.

for use in evaluative judgment in all fields. It has proven impossible to do this for just one field. As the next step in developing a framework for classifying standards of management used in management audits, the general types of standards used in other fields are considered. This description of standards in current use treats only very broad general categories and not specific standards, Since this chapter is undertaken to provide a framework for classifying criteria by which management can be evaluated, only "social science" fields are considered, and only a few of these fields. It is not within the scope of this study to present a list of standards by which management activities can be evaluated. This project must be left to the field of management. Also, no attempt will be made to list and criticize those standards of management already in use. The objective is rather to determine what standards -- what criteria -- are currently being used to evaluate management in the practices of management auditing. This determination will be facilitated by a general classification scheme for evaluative criteria. The development of this classification scheme for management should be consistent with the broad categories used in other major social science endeavors surveyed here. The areas chosen for this brief review are those with professional or semi-professional attributes similar to those that have been attributed to management and other fields of applied social sciences.

<u>General Standards Applying to the Practice of Medicine</u>

The practice of medicine has been granted the status of a profession; the profession of the art of application of medical science. The criteria used to evaluate medical practice in general and doctors in particular can be divided into four broad categories. The first category is that of social criteria. Medical practices concerned with euthanasia and artificially extended life, which are subject to current debate, are evaluated by these social standards. Also the availability of medical aid, regardless of financial status, is a question which must be evaluated by social standards. The Hypocratic Oath formalizes some of these social standards when it states, "I will give no deadly drug to any, though it be asked of me." The second broad type of criteria used to evaluate medical practice is that of law. Many social standards discussed above have been formalized into laws and these laws are used to evaluate the profession in general as well as individual practitioners. The third category of standards apply to a doctor's responsibility to the patient who requests his services. This is an individual responsibility somewhat different from the social and legal responsibilities above. The Hypocratic Oath recognizes this category by the statement, "whatsoever things I see or hear concerning the life of men, in my attendance on the sick or even apart therefrom, which ought not to be noised about, I will keep silence thereon, counting such things to be as sacred secrets." The fourth type of standard by which the medical profession and individual practitioners are judged is that of a reasonable skill in the performance of the art of medicine.

General Standards Applying to the Practice of Law

The profession of law in general and the practice of law by individual lawyers is also subject to evaluation by certain general standards which can be divided into the same four broad categories used for medicine. Law, like medicine, must serve a social function and it is judged by social standards. The basic objectives of formal laws, common laws, and legal practice are to serve and protect society; therefore, the attainment of these objectives can only be evaluated by social standards. Legal practice and laws themselves are also evaluated by certain legal standards. Such is the case when the constitutionality of a law is judged and when the legality of the practice of a particular lawyer is evaluated. A practicing lawyer has a direct responsibility to the client he serves and his practice is judged by this category of standards which sets up criteria somewhat different from those of social and legal standards. In the fourth broad category, lawyers and the legal profession as a whole are judged by standards of reasonable skill in the practice of law.

General Standards Applying to Education

The field of formal education is less organized and somewhat less professional than the fields of medicine and law, but it is considered here because of the current emphasis upon the expanding function of education in general and upon the responsibilities of teachers at the elementary, secondary, and college levels. Education, particularly public education, serves the public interest and, in general, is judged by social criteria. Controversies over the censorship of education material, religion in public schools, integration of public schools, etc., are decided by evaluations based upon social standards. All education in general and public education in particular are judged by legal standards. Most of these laws are formalized social standards which provide more exact standards by which education in general and the actions of individual teachers can be evaluated. A third category of standards by which individual educational institutions and teachers are evaluated is that established by the direct controlling body. The control, which may be a board of education, board of trustees, etc., establishes judgment criteria and interprets the application of social and legal standards. The fourth broad category of standards in education, as in medicine and law, is the criteria used to evaluate the reasonable skill in the practice of the art of education by individual practitioners. The criteria used in this category to evaluate teachers are generally poorly defined, but they do exist in some form.

<u>General Standards Applying to Accounting</u>

Accounting is an applied social science and a brief review of the types of standards used to evaluate accounting will be helpful in establishing a classification scheme for management evaluative criteria. Accounting is currently in the process of clarifying the standards -- principles -- by which its practice is guided and evaluated. Accounting principles apply to the field as a whole; however, references to individual practitioners usually mean the Certified Public Accountant in public practice who has a more clearly defined responsibility for his actions than other accountants. Accounting authors agree that accounting has a social obligation and one type of criterion by which accounting can be judged is that of social standards. Littleton lists several specific social benefits of accounting and states that, "it (accounting) has become in part a social instrument 'to make moral principles practical.'"[16] Accounting in general and the practice of individual accountants are also judged by legal standards. These legal standards are established by regulatory agencies, taxing agencies, and ordinary courts of law. As in medicine and law, the legal criteria are usually more exactly defined than any other standards and the legal standards are usually formalizations of social standards. The third category consists of those standards established by the particular controlling interest served by the accountant. The activities of an accountant practicing within a business firm are evaluated by criteria established by his controlling interest -- employer -- and the work of the independent CPA is judged by standards set up by the controlling interest he serves -- management, stockholders, government, etc. as well as his employer in a firm of Certified Public Accountants. Accountants, particularly Certified Public Accountants, are responsible for a reasonable skill in the art of accounting and a fourth category of criteria used to evaluate accounting is that of the standards used to judge this reasonable skill. Accounting, like all business oriented

[16] Littleton, _op. cit._, p. 14.

endeavors, operates within an economic environment and economic criteria are another type of standard by which accounting is judged. Traditionally, accounting deals with those economic transactions which are of a financial nature and as such its practice is evaluated by economic standards applying to financial recording. Moonitz summarizes his proposed basic postulates of accounting by recognizing that accounting is a form of quantitative expression widely used to report on economic activities and that the basic environment of accounting is economic.[17] This fifth category may be the most important for judging accounting and accountants; however, in this category, usually only very general standards are used.

Auditing Standards

Auditing standards can be classified in the same manner used to distinguish the general types of criteria for evaluating medicine, law, education, and accounting. However, it is necessary to distinguish clearly between those criteria -- auditing standards -- used to judge auditing and auditors and those criteria -- standards -- which the auditor uses to evaluate audit evidence and reach an opinion about the object or activity being audited. The nature of audit standards, as ordinarily used and as used in this section, is that of criteria for describing, measuring, and evaluating the quality of a particular audit or auditor.

[17] Maurice Moonitz, The Basic Postulates of Accounting (Accounting Research Study No. 1) (New York: American Institute of Certified Public Accountants, 1961), p. 51.

The American Institute of Certified Public Accountants has prepared a list of general auditing standards for independent public accountants in which three categories of standards are used: (1) general standards; (2) standards of field work, and (3) standards of reporting.[18] The General Accounting Office of the Federal Government states that its auditors are judged by all AICPA standards as well as additional standards applicable to particular types of GAO audits.[19] Internal auditors serve management and in this service they should perform their audits in accordance with professional standards of technique, objectivity, and integrity.[20]

Of the five general categories used previously to classify standareds -- social, legal, economic, performance skill, and controlling interests -- most of the ten standards of auditing presented by the AICPA are in the category of reasonable skill in the performance of an audit. Social standards are implied in the recognition of the external auditor's responsibility to unknown third parties for his audit opinion. Social standards have also been formalized by law in terms of legal standards for auditing established by government agencies. The Securities and Exchange Commission is particularly active in establishing legal standards for external auditors and for some internal auditors. Auditors are also evaluated by criteria set up by the particular controlling interest --

[18] Committee on Auditing Procedure, Auditing Standards and Procedures: Statements on Auditing Procedure No. 33 (New York: American Institute of Certified Public Accountants, 1963), pp. 15-16.

[19] Ellsworth H. Morse, Jr., "The Case for Accepting GAO Experience," The Journal of Accountancy, V. 109, No. 6 (June, 1960), pp. 62-63.

[20] E. B. Murray, "Invitation to Progress," The Internal Auditor (Spring, 1964), p. 9.

Congress in the case of the GAO; management in the case of internal auditors; and stockholders, management, government, etc. in the case of the external CPA. Since auditing operates in an economic environment, it is also judged by economic criteria. Implicit recognition of economic standards is evidenced by current emphasis on auditing's responsibility to provide service to management to enable management to do a better, more efficient, job.[21]

The AICPA auditing standards for Certified Public Accountant's audits, which lead to an opinion on financial statements, include a description of the criteria by which financial statements are to be evaluated -- generally accepted accounting principles, consistent application, and adequate disclosure. The emphasis in this study is upon the criteria used by various auditors to evaluate management in current management audits. The standards used to evaluate the audit are of secondary interest; however, since the quality of an audit is important in determining its reliability and since this study should lead to a conclusion as to which auditors, if any, are qualified to perform a management audit, the criteria used to judge auditors will also be considered in subsequent chapters.

Classification Scheme for Management Audit Criteria

Since management audits culminate in a report based upon the

[21] Carl Tietzen, "Changes in Public Accounting," The Journal of Accountancy, V. 105, No. 5 (May, 1958), p. 87.

examination of managements' financial and economic plans, policies, and activities, an investigation of current management audits must include a description of the types of criteria that are used to evaluate evidence obtained in the audit examination. The classification scheme developed should include all types of criteria with a minimum of duplication; any specific standard should appropriately fit some category of the classification. However, the classification is not intended as a listing of specific management standards. The five categories used are:

1. standards from the social environment of management.
2. standards from the economic environment of management.
3. standards from the legal environment of management.
4. standards from requirements of the controlling interests of management.
5. standards from requirements for skillful management performance.

As used in the above list, environment is a general term which distinguishes those factors influencing business management which cannot be directly controlled by management. What constitutes the environment in any given instance is relative and varies with the level at which an activity takes place; however, the concept of environment as external factors not directly controlled remains the same.[22]

[22] J. Boddewyn, "The Environment of Business," Mississippi Valley Journal of Business and Economics, V. II, No. 1 (Fall, 1966), pp. 2-3.

Standards from the Social Environment of Management

Many management specialists and authors in the field of management take the position that there is a professional, public service aspect to management. If this is the case, then management's plans, policies, and activities are subject to evaluation by certain social standards. In an article on management decision theory, Tannenbaum points out that management's decisions must be considered in a social context.[23] In a similar article, another author justifies the importance of management's social responsibility by the fact that, "the management practices of the 200 largest corporations strongly influence three-quarters of U.S. business life."[24] The use of social criteria to evaluate management may not be appropriate for all organizations, but its use is appropriate for large corporations and most public utilities. Boddewyn writes that:

> concern with "social responsibilities" has made businessmen look beyond the confines of their offices, their firms, their industries, and toward the economy, the society, and the world -- even the next one. These views are in the process of displacing more detached visions of a business system free of concern about what takes place in its environment.[25]

Recent public concern about general price increases, public transit service, and automobile safety are evidences of the evaluation of management's plans, policies, and activities in terms of social

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[23] Robert Tannenbaum, "Managerial Decision Making," The Journal of Business, V. XXIII, No. 1 (January, 1950), p. 23.

[24] Herrymon Maurer, "The Age of Managers," Administrative Control and Executive Action, B. C. Lemke and James Don Edwards, editors (Columbus, Ohio: Charles E. Merrill Books, Inc., 1961), p. 72.

[25] Boddewyn, op. cit., pp. 1-2.

standards. Other examples of social standards applicable to management are: adequate financial reporting, reasonable wage rates, and fair employment practices.

Standards from the Economic Environment of Management

The economic environment is that part of the overall social environment which is defined in general as the allocation of scarce resources among unlimited wants. The economic environment of management includes both long-run and short-run factors of maximizing overall economic profits. Economic criteria used in this study are limited to those conditions affecting the operation of a particular organization and which are appropriate to evaluate the plans, policies, and activities of the management of one organization. It is possible that the operations of some large organizations can affect the general economy more than the general economy affects their operations, however, in this classification these will be considered a part of the social environment. The economic criteria in this category are those that can be used to judge managements' fulfillment of its responsibility for plans, policies, and activities which anticipate economic changes and utilize the organization's resources to maximize long-run or short-run utility.

There is a close relationship between the economic functions and the social consequences of actions of management. To adequately understand management (and to evaluate management) this relationship must be understood.[26] Boddewyn writes that even though the current "age of

[26]Maurer, op. cit., p. 79.

affluence" has pushed economic problems and economic impulses into the background, the economic environment still remains the main one for business.[27] The valuation or understanding of the functions of management can only be accomplished by using some economic standards. If current management audits judge the economic functions of management, the judgment criteria used are of this type. Dewing lists four economic causes for business failure. These are types of economic criteria that may be used for this purpose: (1) inability to meet excessive competition, (2) undertaking poor programs of expansion, (3) failure to forecast changes in public demand, and (4) failure to conserve capital.[28] Other types of economic criteria could be the economic effects of new products, the use of advertising, and diversification through expansion.

Standards from the Legal Environment of Management

Many standards guiding the operations of organizations have been made more precise and formal through laws. Statutory laws and pronouncements of government regulatory agencies establish a general framework within which an organization must operate as well as a specific requirement for many activities. Management of an organization must operate within legal constraints; its plans, policies, and activities

[27] Boddewyn, op. cit., p. 6.

[28] Arthur Stone Dewing, The Financial Policy of Corporations (fifth edition; New York: The Ronald Press Company, 1953), II, pp. 1218-19.

must conform to laws and regulatory pronouncements. Legal consraints vary by type of organization such as public utilities more directly affected than others. Managements' plans, policies, and activities can be evaluated by the criteria established in law and regulative rulings. Some examples of these criteria are: federal and state labor laws, tax laws, civil rights laws, anti-trust laws, fair-trade laws, etc.

Standards from the Requirements of Controlling Interests of Management

Organization management is directly responsible to some controlling interest. It is possible that management and control are the same, but usually there is a separation. As organizations increase in size there is usually an increase in the separation of management and controlling interest. Control may be by directors, owners -- stockholders -- or Congress in the case of government agencies. Management's discharge of its responsibility to its immediate superiors is evaluated and certain criteria are used for this evaluation. One author suggests a management audit as a means of improving stockholders' control over self-perpetuating management.[29] If current management audits of plans, policies, and activities are to judge the discharge of this requirement, criteria of this type are necessary and can be included in this category. The general rule of an organization system, that actions or decisions by a member of a group be consistent with the

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[29] Ernest Dale, "Management Must be Made Accountable," Harvard Business Review, V. 33 (March-April, 1960), pp. 52-59.

group end and not personal ends,[30] is one example of the criteria of this type. Other examples are: owners' or directors' directives, Congressional intent, corporate charters, policies established by stockholders' vote, and dilution of stockholder's interests by operations in treasury stock or stock options.

Standards from Requirements for Skillful Management Performance

Good management should be skilled in the application of management techniques of planning, establishing policies to implement plans, and decisions controlling daily operations of an organization. In this category the criteria used to evaluate management's performance emphasize the techniques used by management in complying with the prior categories of social, economic, legal, and control standards. Dewing recognizes that certain economic conditions will lead to business failure, except under the leadership of men of great managerial skills,[31] and this category includes those criteria by which this management skill is evaluated. Current audits of the management of limited aspects of an organization, as conducted by internal auditors and GAO auditors, use this type of standard. With these standards, management's performance is evaluated at a level which may be of less materiality than those activities normally judged by social, economic, legal, and control standards. An example of the type of criteria included in this category are the

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[30] Tannenbaum, op. cit., p. 33.

[31] Dewing, op. cit., p. 1217.

criteria used internally for judging the qualities of managers for promotion or salary adjustment.

Limitations of the Classification Scheme for Management Audit Criteria

The choice of a classification scheme which is useful in describing standards currently used to evaluate management audit evidence is limited by the general definition of standards. The brief review of literature on standards shows that almost anything can be used as a basis for measuring, communicating, or evaluating; therefore, the categories used to classify useful standards must be general enough to include a wide range of standards. The classification scheme is not a description of specific management standards. Its use is limited to that of a framework for classifying and describing those criteria currently used to evaluate management audit evidence. The subsequent chapters of this study concern this classification and description of standards used in several types of management audits.

CHAPTER V

MANAGEMENT AUDITS BY INTERNAL AUDITORS

The first four chapters of this study provide a framework for understanding the concept of management auditing as it currently exists. This chapter is the first of four which investigate specific applications of this type of auditing. The purpose of this chapter is to investigate and analyze the nature of management auditing as conducted by various groups of internal auditors. There are a wide variety of audit practices in internal auditing and this study analyzes and summarizes the approach to management auditing used by the internal audit practitioners and authors. In this investigation the relationships between the nature of internal auditors' management audit clients, subject matter, services, and the criteria used to draw conclusions from audit evidence are considered. Some internal audit findings, and the expressed or implied criteria which support these findings, are illustrated to describe the internal audit approach to management auditing, theory, and practice.

Since internal auditors are the most active group both in conducting a type of management audit and in publishing material about this management auditing, their activities are considered in this chapter to support the assumptions made in previous chapters that management auditing is a part of the general theory of auditing and that criteria for the interpretation of management audit evidence do exist and are being used. An analysis of the general background, present practice, and future trends of management auditing by internal auditors will provide a better understanding of its possibilities, limitations, and its relationship to general auditing theory. Also, this description of the type, nature, and quality of contemporary management audits, will furnish a basis for the conclusion as to whom, if anyone, is qualified to conduct such audits.

The approach of this chapter is to briefly present the historical background of internal auditing and the current status of its management auditing -- generally known as operational auditing. This is followed by an analysis of current operational audit practices. Since internal auditing is a very diverse field and there are a wide variety of operational auditing practices, the primary sources of material for this investigation are limited to pronouncements by the Institute of Internal Auditors and descriptions appearing in published books and articles. Audit practices of the Army Audit Agency are presented in more detail as an illustration of one specific approach to this type of auditing done in the Federal Government and to the standards used to judge operational auditors and operational audit evidence.

The term operational auditing is sometimes used to describe that part of internal auditing which considers a company's operating activities rather than financial activities, and management auditing is the general term used to distinguish audits of managements' plans, policies, and activities from audits of the accuracy of financial records. However, in more general usage, operational auditing is defined as the internal audit activities which evaluate and appraise all management plans, policies, and activities of a company. Operational auditing is the type of management auditing done by internal auditors. This latter usage will be employed in this study.

Historical Background and Current Status of Operational Auditing by Internal Auditors

Internal auditing developed as a tool for management control within an organization, and, as the management control needs extended beyond the need for accurate reports of financial data, the scope and nature of internal auditing expanded to serve management better. Historical information about internal auditing prior to 1940 is limited because at that time it was usually not a separate management control function. Auditing was used internally long before there was a separation of ownership and management requiring external audits; however, most literature on auditing history emphasizes the growth of the independent audit function. The manorial period in England served as the development period for external auditing, government auditing, and internal auditing. Lamperti and Thurston state that while the origins of internal auditing are not known, its antecedents go back to the first days of accountability and English merchants and feudal lords recognized the need for objective verification of subordinates' reports.[1]

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[1]Frank A. Lamperti and John B. Thurston, Internal Auditing for Management (New York: Prentice-Hall, Inc., 1953), p. 164.

Railroads were among the first companies to recognize the need for internal auditing as a separate function to control their widespread operations and by the early 1900's other companies with geographically dispersed operations were using traveling auditors. The nature of this early internal auditing is described as follows:

> In its beginning, internal auditing was largely a clerical activity established primarily for the detection of fraud. Then its scope was broadened in some companies to include such matters as reconciliation of bank accounts, audits of payroll, verification of customers' accounts, and the checking of mathematical accuracy of certain accounting documents.[2]

In the 1930's the external audit requirements of the Securities and Exchange Commission caused a number of companies to establish internal auditing programs along lines similar to those of outside auditors. Internal auditors were used to supplement the activities of outside auditors and often to reduce the extent of the external audit. At this time a broader concept of internal auditing began to develop -- that of constructive service to all members of management, operating as well as financial.[3]

The Institute of Internal Auditors was formed in 1941 and is exclusively devoted to the field of internal auditing. The nature of internal auditing as defined by a 1947 Statement of Responsibilities was as follows:

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[2]A. H. Kent, Capsule Course in Internal Auditing, (New York: The Institute of Internal Auditors, 1961), p. 6.

[3]Ibid., pp. 6-7.

> Internal auditing is an independent appraisal activity within an organization for the review of the accounting, financial, and other operations as a basis for protective and constructive service to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters but it may also deal properly with matters of an operating nature.[4]

In 1957 the Statement of Responsibilities of the Internal Auditor was issued in a revised form which emphasized the operational audit approach. This current definition no longer contains the restriction that "it (internal auditing) deals primarily with accounting and financial matters." The overall objectives of internal auditing are described as assistance to all levels of management, whether financial or operating, and as assistance with any phase of business activity.[5] Current internal auditing is a broad business function, the scope of which depends upon the abilities of an individual auditor, however, the pronouncements by the Institute indicate what its members consider good internal auditing.

Internal auditing began with the performance of clerical activities primarily directed toward fraud detection. These activities were expanded to include the verification of the accuracy and propriety of accounting records and more recently to include general evaluation of financial management. Currently internal auditors evaluate and constructively criticize all levels of management, whether financial or operating. This current internal auditing practice, which is considered

[4]Victor Z. Brink and Bradford Cadmus, Internal Auditing in Industry (New York: The Institute of Internal Auditors, 1950), p. 6.

[5]The Institute of Internal Auditors, (New York: The Institute of Internal Auditors, 1962), p. 5.

in this chapter, includes the review and appraisal of the activities, policies, and plans of a company in order to aid the conduct of all company affairs on a sound, economic, and ethical basis.[6] Internal audit development has been in the form of expansion rather than evolution in that the original clerical and verification activities are usually still performed.

The Nature of Internal Auditors' Operational Audit Clients and Subject Matter

The nature of operational audits by internal auditors is dependent upon the particular audit client served, the audit subject matter, and the auditor's responsibility for his opinions and conclusions. Internal auditors serve management and all consideration of audit responsibility and subject matter is limited by the fact that the practice of any individual auditor is whatever management wants it to be. However, a general pattern of audit practices and responsibilities is revealed in current articles and the Institute's publications.

Responsibility to Audit Users

Internal auditors are directly responsible to management for the results of their audits. Responsibility to interests outside the organization and to the personnel in charge of the activities audited are secondary. In most instances operational audit reports do not go directly to top

[6] Frank Lennon, "Where Are We Going as a Profession," The Internal Auditor, V. 20, No. 4 (Winter, 1963), p. 14.

management -- president or chairman of the board of directors -- but are submitted to a second level, such as to the controller or financial vice-president. Evaluation of the quality and usefulness of operational audits is made by this second level of management. There is general agreement that the internal auditing department should be responsible to an officer of the organization of sufficient rank to assure a broad scope of activities and adequate consideration of the findings and recommendations resulting from operational audits.[7]

To conduct operational audits, the executive to whom internal auditors are responsible for their reports and who gives them authority to conduct audits must have entree to all operating departments. A 1957 survey of internal auditors in 322 companies found that 60 per cent of the internal auditors surveyed were responsible to the controller or treasurer, 16 per cent to a vice-president, and 14 per cent to the president or board of directors. Of the 44 reporting directly to the president or board of directors, 30 were in banking and insurance companies.[8] Some examples of the level of management to which current internal auditors are responsible are: (1) the controller in the American Telephone and Telegraph Company,[9] (2) the finance department

[7] Bradford Cadmus, Operational Auditing Handbook (New York: The Institute of Internal Auditors, 1964), p. 21.

[8] Internal Auditing in 1957: Research Committee Report No. 5 (New York: The Institute of Internal Auditors, 1958), pp. 17-18.

[9] Donald F. MacEachern, "Internal Auditing on the March," The Internal Auditor, V. 20, No. 3 (Fall, 1963), p. 32.

in J. A. Folgers and Company, but with a degree of autonomy similar to that of operating departments;[10] and (3) the executive vice-president in the Detroit Edison Company.[11] An exceptional organization position in the New York Life Insurance Company is cited by its General Auditor who writes that "I am fortunate in being with a company which has established the independence of the General Auditor."[12] In this company the auditor is responsible to an auditing committee of the board of directors.

Internal auditors emphasize the fact that they are organizationally independent of the business functions audited. While this is usually true, the responsibility for operational audits does not exceed the authority to conduct such audits. Audit reports may be addressed to any level of management, but the auditor is directly responsible only to his immediate superior for these reports. Any social or legal responsibility to parties outside the organization must be enforced through management and the responsibility to audited parties is secondary to the responsibility to the immediate superior of the internal auditor.

Operational Audit Subject Matter

The Institute of Internal Auditors states the objective of internal

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[10] James J. Fredman, "Effective Supervision of an Internal Audit Department," The Internal Auditor, V. 20, No. 4 (Winter, 1963), pp. 33-34.

[11] C. J. Ghesquiere, "Auditing for Profit," The Internal Auditor, V. 16, No. 2 (June, 1959), p. 13.

[12] Charles E. Grody, "The Auditor Encounters Computers," The Internal Auditor, V. 16, No. 1 (March, 1959), pp. 31-32.

auditing as the assistance to all levels of management, and the scope of an internal audit should include any phase of business where an auditor can be of service to management. Operational auditors are to audit methods and performances whenever such audits are useful to management. Some of the aspects of management's methods and performances included in operational audit subject matter are: plans and objectives, organizational structure, policies and practices, systems and procedures, methods and controls, means of operation, and utilization of human and physical resources.[13] Recommendations for the scope of operational audits include managements' plans, policies, and activities, and the operating departments' compliance with established management policies.

In the practice of internal auditing, the scope of the operational audit is usually limited to audits of compliance with prescribed policies and procedures rather than audits of the policies themselves. Also the subject matter of each audit is usually limited to one specific activity. The business activity or operation audited is selected from a particular problem area needing attention, a special request by management, or on a rotating basis covering all functional areas. In a 1957 survey of internal audit programs in 322 companies, the following listing of functions audited and the per cent of the internal auditors auditing each function was obtained: Accounting -- 100%; Treasury -- 75%; Purchasing -- 70%; Sales -- 50%; Production -- 30%, Traffic -- 22%; Personnel --

[13] William P. Leonard, The Management Audit (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1962), p. 44.

16%; and Advertising -- 16%.[14] In a recent book on operational auditing, the business functions of purchasing, traffic, scrap, receiving operations, facilities, advertising, and insurance programs are considered important enough subject areas to warrant chapter recognition.[15]

Operational audits follow either organizational or functional lines in selecting the subject matter to be audited, and the subject matter is usually limited to the policies and activities of middle management and first line management. Operational auditors usually do not have the authority to audit the plans, policies, and activities of top management, nor is top management favorable to a review of its activities by company employees.[16] The effective application of operational auditing techniques to the examination of the adequacy of policies and the compliance with established policies and procedures requires that these policies and procedures be well defined. Audits based on operating results can be useful, but the underlying procedures controlling operations must also be considered to identify any weaknesses and to suggest improvements. At the level of supervisory management, the operating procedures are usually clearly established and the adequacy of these procedures and management's compliance with them is auditable. At the level of middle management, many policies and procedures are formalized and, thus,

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[14] Internal Auditing in 1957: Research Committee Report No. 6, p. 10.

[15] Cadmus, op. cit., pp. xi-xii.

[16] Operations Auditing (New York: The Institute of Internal Auditors, 1958), p. 20.

are subject to evaluation in an operational audit. As the activities of middle management become more formalized by the introduction of electronic data processing equipment and scientific decision making processes, the effectiveness and efficiency of established procedures and the compliance with company policy will be more subject to operational audit. The planning, policy making, and other activities of top management are usually not set out as formal policies and procedures. The application of internal operational audits at this level is limited to special areas such as conflicts of interest and expense account charges in which specific policies have been enacted.

Operational audits may consider an entire business function but the audit report and the major audit effort is usually directed toward a specific operating activity. The procedures which narrow the scope of an audit will be considered in more detail later in this chapter. Operational audits emphasize exceptions and some of the activities considered, as reported in The Internal Auditor, are illustrated later in this chapter.

There appears to be a desire to audit the planning and policy making functions of management; however, there is little evidence that this is done except on a limited basis. The current literature on actual operational audit practices indicates that the major subject matter is the compliance with established policies and the effectiveness of the procedures used in operations. Also there seems to be a desire to audit all levels of management; whereas, evidence in current literature shows that in practice most audits deal with lower levels of management. Considering these restrictions, the operational audit subject matter can be any organization activity which can be identified to the degree necessary to have an auditable situation. There is a tendency to use the exception principle in selecting operations to be audited; that is, to audit those activities which will provide reportable findings. Special requests by management can be concerned with any aspect of an organization, and since internal auditors are management employees, these requests may result in activities outside the realm of auditing.

The Nature of Internal Auditors' Operational Audit Service

This section considers the general audit approach and the specific audit steps or phases used in operational audits by internal auditors. The analysis is based upon evidence in current literature of acceptable approaches to operational auditing and its purpose is to go beyond the general statements by The Institute of Internal Auditors and analyze actual practices followed in operational auditing. Internal audit practices are not uniform and generalizations about operational audit services are limited by many exceptions. The approach used here is to present and analyze the basic audit approach, the work done in each stage of the audit, and the limitations of this type of audit.

Basic Approach to Operational Auditing

Operational audits are examinations, appraisals, and reports upon the way in which a particular operation is administered rather than attempts by internal auditors to examine and appraise the technical skills of operating specialists. Some of the factors considered in the operational audits of a major aircraft company are:

1. whether objectives have been clearly defined in conformity with sound business principles and have been communicated to all concerned.

2. whether operating policies conform to established objectives.

3. whether policies are implemented by specific procedures.

4. whether procedures are followed as intended.

5. whether necessary administrative information is accumulated by orderly methods.

6. whether management is provided with adequate, timely and accurate reports.[17]

While not all of these six factors may be considered in each operational audit, they do establish the basic audit approach.

Operational audits emphasize controls, and the one consistent aspect of these audits is the review, appraisal, and evaluation of the control system in relation to general company policy, to controls in other operating areas, and to the requirements of operating management.[18] The most common approach to operational auditing is to analyze the policies, procedures, and controls of a selected function and to trace the effect of any known or suspected weakness to its ultimate effect on operations. However, an alternative approach is

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[17] Frederic E. Mints, "New Developments in Operational Auditing," The Internal Auditor, V. 17, No. 2 (June, 1960), p. 10.

[18] Cadmus, op. cit., p. 24.

to isolate failures in a particular procedure or operation and work back to the basic causes. The auditor of Lockheed Aircraft Corporation writes that this approach is used in the company's operational audits of aircraft production. The objective is "to discover the underlying basic conditions which were responsible for problems encountered in the final assembly and flight testing of the plane so that management might take the necessary steps to effect permanent cures."[19] Operational audits are implemented in several phases which are considered next.

Preliminary study, review, and planning. The objectives of this phase of operational audits are to select the business function to be audited; determine the major objectives established by management for the selected function; review the organization structure, policies and procedures assigned to the function; and to familarize the auditor with the operations, controls, facilities, records, and procedures actually employed. The preliminary phase establishes the possible benefits to be obtained from the audit and isolates those aspects which are to be considered in developing audit programs. In the preliminary phase the auditor used audit procedures such as an inspection tour of the facilities, limited tests of controls and procedures, discussions with management of the audited function, and the accumulation of information about actual operations and their controls.

Internal auditors tend to audit those areas considered important by management and the operational auditor uses the preliminary phase to

[19] Mints, op. cit., pp. 14-15.

learn the aspects of an operating activity that are important to management and total business operations. Since internal auditors are full time employees of an organization, the preliminary phase usually is performed on a continuous basis and cannot be related to a specific audit. In current literature on operational auditing there is no specific comparison between the scope of the preliminary survey and the subsequent detail audit examination. However, from operational audit findings reported, it can be assumed that the scope of the actual audit examination is much narrower than that of the preliminary review phase.

One author lists the aspects to be considered in the preliminary phase as: organization structure, relationships and responsibilities, policies, procedures, documents used, reports used, people in the organization, and major problem areas. In the general preliminary study the auditor defines the extent and limits of the audit and uses this information to develop the audit program and the audit report.[20] Another author describes the preliminary survey as a way of accumulating information without verification. From this information the operational auditor obtains knowledge of management's objectives and problems, the physical layout of the operation, and the significance of the responsibilities assigned to or assumed by the audited function.[21] The preliminary study, review, and planning phase in operational auditing serves

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[20]Arthur H. Kent, "Internal Auditing is an Appraisal Activity," The Internal Auditor, V. 16, No. 3 (September, 1959), p. 39.

[21]Richard W. Osborne, "Practical Aspects of an Operational Audit," The Internal Auditor, V. 17, No. 4 (Winter, 1960), pp. 30-31.

to both orient the auditor and to furnish data for the next phase of establishing audit objectives and preparing audit programs for the specific aspects of a function to be audited in detail. As Cadmus has written, the internal auditor cannot appraise controls unless he knows what is being controlled and how it is controlled.[22]

Establish audit objectives and prepare audit program. The purpose of this phase is to state the preliminary review findings in terms of specific audit objectives and to define these audit objectives and the means of accomplishing them in terms of an audit program. Operational audit programs usually do not specifically describe the type and extent of audit tests to be conducted nor the limits of the audit scope. At this stage the audit has progressed from a general, non-examination survey of an entire business activity or function to the identification of the areas in which significant weaknesses may exist. Audit programs direct the operational auditor to those activities to be audited and the applicable policies, procedures, and activities to be considered. The type of audit tests and their extent is decided during the detail examination and is based upon information obtained as the audit progresses.

Audit objectives and audit programs vary, but in most cases they are stated in general terms such as, "to determine whether or not the company has due regard for full compliance with all local, state, and federal regulations."[23] The audit program, even in its briefest form,

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[22] Cadmus, op. cit., p. 26.
[23] Leonard, op. cit., p. 82.

indicates the area covered by the audit, the facts necessary for the audit examination, and the approach to an orderly accumulation of necessary audit evidence.[24] An internal auditor at Lockheed Aircraft Corporation writes that Lockheed's operational audit programs are of the questionnaire type and that the programs are based on the three basic business principles of cost, quality, and timeliness. Their programs do not indicate the extent of audit tests to be conducted; this is decided later.[25] In another illustration of the nature of operational audit programs, the Controller of Chrysler Corporation writes that his company has found that the performance of a number of pilot audits is useful in refining the audit program and familiarizing audit personnel with the audit objectives. He also suggests that at this stage of the audit the objectives should be discussed with management of the audited activity.[26]

Detail audit examination. The detail operational audit examination phase consists of collecting, recording, summarizing, and evaluating audit evidence. The established audit objectives are attained by following the operational audit program. Since the audit program is of a general nature and problem areas are only tentatively defined, the detail examination accomplishes both the actual collection and evaluation

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[24] Kent, op. cit., p. 41.

[25] Osborne, op. cit., pp. 31-33.

[26] Murray Kane, "A Clarification of the Broadened Role of Internal Auditing," The Internal Auditor, V. 18, No. 1 (Spring, 1961), p. 53.

of audit evidence and the decisions as to which areas, if any, are to be subject to extensive testing. In this phase of the operational audit, management deficiencies are identified and investigated to the extent necessary to prepare an audit report. Operational audit tests are applied to the entire areas set out by the scope of the audit program so that the auditor obtains general knowledge about the business functions involved; however, only those areas in which significant weaknesses are found are subject to extensive testing.

The basic types of audit evidence collected are physical, documentary, testimonial, and analytical; but, in general, operational audit evidence can be any objective, factual data that are useful. Audit evidence can be obtained from any source and objective observation of actual operations is a common starting point for the development and collection of evidence about a specific deficiency. Audit evidence obtained is accumulated in audit working papers to aid in its interpretation and in report preparation. There is no standard set of techniques and procedures used in operational auditing to collect and evaluate evidence; however, the techniques include those of examination, confirmation, inquiry, observation, comparisons, and any others useful in attaining audit objectives.

The many-faceted activities of the operational audit detail examination or field work are summarized by one author as:

1. analysis of the detailed steps and controls of a function, and the written procedures, if any.

2. determination of standards of performance from written

procedures or from discussion with supervisors.

3. ascertaining the volume of items subject to test.
4. determining how to make an unbiased selection of items to examine.
5. describing the detail audit steps proposed and their specific objective.
6. making the detail verification, summarize and analyze test results.
7. forming an opinion or procedures and performance and any necessary corrective actions.
8. discussing any findings and suggested corrections with line supervision.[27]

The most significant characteristic of this audit phase is that it involves tests of a single aspect of a business organization and these tests are tailored to the particular organization system being audited. Statistical sampling techniques are frequently used to determine those weaknesses in procedures, controls, or operations which are followed up in detail.

Audit reporting. The most important phase of operational auditing is that of reporting. The objective of the report is to inform management of audit findings and the audit opinion on these findings. While many authors recommend the reporting of both positive and negative findings, in actual practice the principle of management by exception applies to operational audit reports. The main criterion by which audit reports to management are judged is that they must be useful to management.

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[27]Osborne, op. cit., pp. 33-34.

Audit reports are submitted to various levels of management depending upon the nature of the audit findings and the management level to which the auditor is responsible. Often detail reports are submitted to the operating departments involved and only summary reports are sent to the top levels of management.[28] Informal reports of minor findings are settled at the level of lower supervisors while major findings and recommendations are reported to senior company executives and the heads of the operating departments involved.[29]

There seems to be general agreement that surprise audits and confidential operational audit findings are inappropriate since the success of the audit requires management cooperation in the conduct of the examination and in the preparation of a useful audit report. The follow-up on deficiencies and recommended improvements is an integral part of operational auditing by internal auditors. While most reports emphasize specific findings and suggested improvements, a few auditors report both positive and negative factors and report their overall opinion on the supervisory management involved.[30]

Criteria Used to Evaluate Operational Audits and Auditors

In the 1957 Statement of Responsibilities of Internal Auditors,

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[28] Dudley Taylor, "Development and Implementation of Functional Audits," The Internal Auditor, V. 17, No. 1 (March, 1960), p. 57.

[29] Cadmus, op. cit., p. 31.

[30] Osborne, op. cit., pp. 36-38.

the Institute of Internal Auditors lists several factors which govern the quality of auditors and internal audits. Some of these factors are: (1) the internal auditing is a staff rather than line function and the audit review and appraisal does not relieve other persons in the organization of the responsibilities assigned to them; (2) the auditor must have organizational independence; and (3) internal auditors must take an objective attitude and, therefore, should not develop and install procedures, prepare records, etc. that will be subject to later internal audit review and appraisal.[31] However, The Institute of Internal Auditors is organized and operated as a voluntary association for the promotion of educational, ethical, and social interests of internal auditors and has no authority to judge the work of its members. There is no evidence that the Institute has the power to expel or admonish members not conforming to its pronouncements. The evaluation criteria established by the Institute are advisory only and there is no way to measure their effectiveness.

Internal auditors are employees of the organization which they audit and the only meaningful criteria by which audit activities are judged are those established by management of the organization. The only valid generalization that can be made is that operational audits must be useful to management. As illustrated in the following section on specific audit findings, operational audit usefulness is usually measured in terms of dollar savings to justify the application of audit resources to a particular activity.

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[31]The Institute of Internal Auditors, pp. 5-6.

Criteria Used to Interpret Operational Audit Evidence

Chapter IV of this study develops a framework of standards which can be used to evaluate management. The purpose of this section is to describe and illustrate the criteria currently used in operational audits in terms of the categories of standards as defined in Chapter IV. The quarterly publication of The Institute of Internal Auditors, The Internal Auditor, is used as a source of examples of audit findings and the criteria used to develop opinions on these findings. These examples consist of actual case histories as reported by practicing internal audit members of the Institute and serve as examples of both the types of operational audit findings reported and the means of evaluating these findings.

Social Criteria Used by Internal Auditors

Operational audits by internal auditors are directed primarily at supervisory levels of management and their compliance with established company policies while management's social responsibilities are discharged at top management levels. The social criteria that could be used, such as fair employment practices, adequate provisions for worker safety, reasonable pension plans, etc. are of limited application in the current practice of operational audits by internal auditors. Some examples of operational audit findings which deal with management's social responsibilities are: (1) poor plant housekeeping which resulted in danger to employees, low employee morale, and customer complaints; (2) failure to notify employees of eligibility to join a pension plan; and

(3) unsafe material handling procedures risking serious injury to employees. Social criteria are of limited use in operational audits of business organizations, but are more applicable in Government agencies such as the Army which will be considered in more detail later in this chapter.

<u>Economic Criteria Used by Internal Auditors</u>

Economic goals, as measured by the effective and efficient use of physical and human resources, are the primary mission of most organizations. Therefore, the standards set by controlling interests in an organization and the standards for reasonable managerial skills considered later are based upon economic criteria. Also, it is impossible to isolate those standards -- social, legal, or economic -- which do not reflect on management's skills. Major economic decisions are usually made by top management which is seldom subject to operational audits by internal auditors. Within the above restrictions, some examples of actual operational audit findings which use economic criteria are: (1) an uneconomical system of rebates to small customers resulting in excessive record keeping, (2) costly and inefficient raw material handling procedures resulting in excessive costs and ineffective practices, (3) lack of procedures or policies to check weighing scale accuracy resulting in uneconomical overweight safety factors in products, (4) uneconomical use of excessive packing materials as determined by a comparison of basic needs to actual usage, and (5) uneconomical policies for insurance on car rentals as determined by comparison with costs of self insurance. Since internal auditors prefer to state operational audit findings in dollar terms, economic factors and measures are used in the other categories of standards considered here.

Legal Standards Used by Internal Auditors

Most organizations are subjected to an increasing number of legal requirements and audits of compliance with legal standards are within the realm of operational audits by internal auditors. Current literature, however, contains very little evidence of operational audit findings of failures to meet legal standards. Reports of management deficiencies in tax policies and procedures all consider only tax overpayments. It is logical that there would be a comparable number of deficiencies in terms of tax underpayments. Findings of illegal policies, procedures, and practices of management probably do not enter formal written reports which may later be used as evidence against the company. Also, findings of this type are probably not published by the organization and its auditors.

Limited examples of legal criteria used to evaluate operational audit findings are: (1) the legally questionable policy of using endorsed utility bills as negotiable instruments, (2) questionable policies in the implementation of a pension plan, and (3) legal retention periods for records and documents. The auditor of General Electric indicates that his staff conducts an extensive audit examination of compliance with price fixing and conflict of interest policies and procedures, but he does not identify any audit findings in these areas.[32] He points out that the operational audit considers both the establishment of adequate policies and procedures and the compliance with these policies and procedures.

Standards of Controlling Interests Used by Internal Auditors

The ultimate controlling interest of any business organization is its owners -- stockholders. This interest is represented either directly by owners or indirectly by a board of directors. Since the internal auditor is usually not directly responsible to owners or to the board of directors, those standards set up by owners, which are useful in operational audits, are those which establish the duties and responsibilities of various levels of management. There is little evidence that current operational audits consider the relative profitability, economy, and efficiency of the total organization which is the primary concern of controlling interests. Rather, operational audits examine specific policies, procedures, and activities which are only indirectly of interest to controlling interests.

One criterion used in operational audit findings that can be directly traced to controlling interests is that operations are to benefit the organization as a whole rather than individual departments or functions. Some examples of operational audit findings based upon this criterion are: (1) inaccurate and inconsistent treatment of freight traffic in various departments due to a lack of communication and a lack of

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[32] Edwards B. Murray, "Conflicts of Interest," The Internal Auditor, V. 19, No. 3 (Fall, 1962), pp. 18-20.

centralized operations, (2) a lack of communication and coordination between engineering and purchasing which resulted in excessive raw material costs, (3) a deficient order processing system which resulted in poor coordination between production and shipping departments, (4) a lack of communication and coordination between purchasing and operating departments which resulted in unnecessary outside storage, and (5) improvements in material handling procedures developed at one plant of a multi-plant company which were used to evaluate procedures at other plants and recommend improvements.

Standards of Reasonable Management Skill Used by Internal Auditors

This category can be defined as including all criteria useful in evaluating management, however, in this study, the category includes standards of good management based upon the compliance with established policies and procedures and the establishment of effective and efficient operating procedures which are the responsibility of the level of management being audited. Some examples of operational audit findings which apply the criteria of reasonable management skill are: (1) deficient operating controls due to a lack of standards of production, (2) inadequate procedures for obtaining accurate cost estimates at the time of project bids, (3) uneconomical purchase policies which do not comply with stated management objectives, (4) failure to follow established procedures when recording lost parts, (5) failure to consider legal holidays when scheduling freight shipments which resulted in excessive freight demurrage, (6) inadequate procedures for reviewing service contract charges, (7) maintenance of an unofficial record system rather than changing the present system to meet needs, (8) an inappropriate Min-Max inventory reorder system which resulted in excessive inventory, (9) inadequate supervision of factory workers -- the foreman did not know the employees assigned to him and their present job assignment, (10) lack of clearly stated policies for doing business with former employees, and (11) invalid statistical results due to use of poor sampling techniques in inspecting products. One author writes that the best source of standards for evaluating the skill of various levels of management are those standards of performance established by management for itself. These standards would include both written standards and unwritten reasonable standards of performance.[33]

Summary of Operational Audits by Internal Auditors

Internal auditors are employees of the organization audited; therefore, their responsibility is to their immediate superiors in management. Internal auditors are usually responsible to middle management such as the controller or treasurer and have only indirect responsibility to top management or outside interests of their organization. Operational audits by internal auditors cover the full range of business activities from management's plans, policies, and activities to operations; however, most are only indirect audits of management through examination of

[33] Osborne, op. cit., p. 34.

operations as they reflect management actions. The audits consider mainly supervisory management; very few audits are directed toward top management and middle management. The audit subject matter can be any phase of a business requested by management.

The audit service can be anything that assists management. Audits tend to be limited to an area in which specific findings can be developed and reported. Audits by exception are used moving from general topics to specific aspects which can be examined in detail. The audit emphasis is upon control and administrative action rather than technical skill and audits of compliance with prescribed policies seems to be most common.

Criteria used to evaluate auditors and audit results are any that management sets up. Some of the requirements that seem to be general are that internal auditing must be a staff rather than line function to maintain organizational independence and that the audit results must benefit the organization economically. The criteria used to evaluate audit evidence in operational audits are also dependent upon the objectives management establishes. In general, any useful evidence is evaluated by any useful standards. In practice, evidence is evaluated by standards established by management which are those of the controlling interests. Social and legal criteria do not appear to be used much, except as their application is interpreted by top management. Reasonable managerial skill in the sense of economic efficiency appears to be the most useful criteria.

Requirements for successful operational audits by internal auditors. The requirements apparent from the preceding investigation are summarized here in the approximate order of their importance.

1. management must want an audit and an audit of the specific management or operation.

2. the auditor must be organizationally independent and his audit must not relieve the auditee of responsibility.

3. the area audited must have well defined policies, procedures, and activities.

4. the audit subject must be narrowed to a specific problem which is identifiable and for which specific objectives and programs can be developed.

5. audits must be conducted with management cooperation, not as confidential or surprise audits.

6. to be a continued success, the audit must produce measurable benefits.

Limitations of operational audits by internal auditors. The following list includes some of the more important factors that limit the scope and success of operational audits as reported in current literature. There is some duplication between these limitations and the requirements listed above due to the reciprocal nature of the items. The limitations are listed in the approximate order of their importance.

1. audits are limited to subjects which management approves and authority is usually limited to the middle management level which effectively eliminates audits of top management.

2. audits are limited to specific problem areas rather than directed to more general topics.

3. audits must result in measurable benefits and are often limited to negative findings.

4. there is no uniform control over the quality of audits or auditors.

5. as employees, internal auditors duties may not all be auditing and may compromise audit independence.

Up to this point, the analysis and description of operational auditing by internal auditors has considered only audits in private enterprises. Internal auditing in the Federal Government is usually more comprehensive than in private business and, as an example of this large segment of internal auditing, the nature of auditing by the Army Audit Agency is investigated next.

Management Auditing by the U.S. Army Audit Agency

The U.S. Army Audit Agency is used as an example of internal auditing because its size permits full utilization of operational audit techniques and its audit activities and responsibilities are well defined. The Agency audits the U.S. Army, which is one of the largest organizations in this country; it employs over one thousand auditors. Since the relative success of Army operations is not judged by a profit measure, management techniques of inspection, internal audit, and other controls are important and well developed. The objectives, policies, procedures, and activities of the Army are well defined, and, therefore, readily susceptible to a management audit of the effectiveness and efficiency of financial and operating management. For these reasons the audit activities of the Army Audit Agency are useful in this study as an illustration of one type of management auditing.

The approach used in this section is to consider the historical background and current status of Agency audits; its audit responsibilities, audit subject matter, audit service, and the nature of the criteria used to judge audits and audit evidence. The sources of information for this analysis include regulations, audit guides, audit reports, and discussions with audit personnel of the Army Audit Agency.

Historical Background and Current Status of the Army Audit Agency

Auditing in one form or another has been present in the Army since its first formation in early colonial days and the Army Audit Agency was established in 1948 to consolidate the widely scattered auditing activities into one group.[34] Since 1948 the Agency has been a functional activity of the Office of Comptroller of the Army and its development of operational auditing has closely paralleled the development of operational auditing by the Institute of Internal Auditors. Regulation No. 36-5, which establishes the authority, responsibilities, organization, and general policies of the Agency, was first issued in 1953 and has been frequently revised to reflect changing audit objectives. In 1955 a single audit concept was installed in which the activities of an Army installation, its outside contracts, and applicable records at the outside Contractor's office were audited as one combined unit.[35]

In July, 1965, audits of defense contracts were assigned to a

[34] Stanley W. Jones, "Auditing in the Army," The Federal Accountant, V. XIII, No. 2 (December, 1963), p. 34.

[35] Joseph D. Ransey, "The Changing Organizational Structure of the U. S. Army Audit Agency," The U. S. Army Audit Agency Bulletin (March, 1964), pp. 35-37.

separate Defense Contract Audit Agency under the Office of the Secretary of Defense; the Army Audit Agency retained the responsibility for audits of all military commands, installations, activities, and civil functions of the Army.[36] This division led to the further development of management audits of the policies, procedures, and activities of the Army itself, and this study will consider only this type of audit activity.

Army regulations state the purpose of Agency audits as: To provide command and management at all levels with an independent, objective, and constructive evaluation of Army's management and control systems and procedures, and their implementation, including economy of operation, with recognition of the responsibility of The Inspector General of the Army in these areas. All organizational elements and levels of operations are subject to independent and comprehensive audit review and appraisal. Audit activities will be directed toward determining whether management controls at all levels are adequate in concept and effective in application. Reports of audits will include facts ascertained together with related recommendations for appropriate levels of command and management.[37] The various types of management audits, which will be considered in more detail later in this chapter, culminate in a report of major findings, recommended improvements, and an opinion on the overall effectiveness and efficiency of management of the Army installation or function audited.

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[36] "Auditing Service in the Department of the Army" (Unpublished Army Regulation No. 36-5. Washington: Headquarters, Department of the Army, 1965), p. 1.

[37] *Ibid.*, pp. 1-2.

The Nature of Army Audit Agency Responsibilities and Subject Matter

The Army Audit Agency is a part of the Army -- special staff under the general staff supervision of the Comptroller of the Army -- and audits only the Army. The Agency is directly responsible only to the Army and its formal audit reports are made to the Comptroller who forwards them to appropriate officials for any necessary action. Copies of major reports are sent to the Secretary of the Army, and in special audits, which are described later, the audit report is made directly to the command audited. As in other internal audit organizations, secondary responsibilities for audit activities must be implemented by the immediate management superior, in this case, the Comptroller. Secondary audit responsibilities of the Agency include responsibilities to the public, higher Army management, and the Army command of the function or installation audited.

The Army is a public agency and must operate in the public interest. The Legislative and Executive branches of the Federal Government represent this public interest, and, through the Secretary of Defense and the Secretary of the Army, constitute top management of the Army. Audit reports are not available to the public and the Agency does not assume direct public responsibility. Army regulations also state that the audit report will not be construed as relieving accountable or responsible officers of pecuniary liability nor as governing disposition of records or relief from accountability.[38]

[38] Ibid., p. 5.

<u>Audit scope and selection of audit subject matter</u>. Audit subject matter includes all phases of Army operations using appropriated funds and some of the audit activities conducted are: (1) examining and appraising policies, systems, and procedures; (2) ascertaining proper resource utilization and accounting; (3) ascertaining reliability of records and reports; (4) appraising performance and compliance with established policies, procedures, regulations, and laws; and (5) disclosing waste, inefficiency, and other uneconomical conditions and practices.[39] To accomplish the audit objective of reviewing management's effectiveness and efficiency, the Agency conducts four general types of audits; installation audits, vertical audits, lateral audits, and special audits.

<u>Installation audits.</u> These audits make up about seventy percent of the Agency's auditing, and in fiscal 1966 these audits took 154, 879 man-days of audit effort. Installation audits, often referred to as site audits, are conducted at all Army installations on an approximate eighteen month rotating basis. These audits are an examination and appraisal of: (1) the operations relating to the basis, management, and application of resources in accomplishing the missions of the installation; (2) the effectiveness of policies, plans, and operating procedures; (3) the adequacy of command, administration, supervision, and control over activities relating to resources of men, materials, and funds, and (4) the reliability of reports prepared by the installation.[40] All installation

[39] <u>Ibid.</u>, p. 2.

[40] "Guides for Auditing United States Continental Army Command Installations" (Unpublished, USAAA Manual, Section 353-1. Washington: Headquarters, U.S. Army Audit Agency, 1964), p. 3.

audits result in an audit report which inludes an opinion on the overall evaluation of the management of the installation, any deficiencies found, and recommended improvements. Audit reports are submitted to the Comptroller of the Army and to the command of the audited installation. Any subsequent follow-up on deficiencies and suggested improvements is initiated by the Comptroller.

Vertical audits. The examination, analysis, and report on a particular Army function at all or at a substantial number of the installations involved is known as vertical auditing. These audit projects are usually initiated by the Army Audit Agency with the approval of the Comptroller of the Army and are selected on the basis of those areas in which an audit will provide useful information from both the long-run and short-run point of view. At the close of this type of audit, a report is issued to the Comptroller and to the installation commands involved. The audit report is a comprehensive, Army-wide evaluation of the audited subject; it includes an opinion on the effectiveness and efficiency of management and lists any applicable deficiencies and recommended improvements. An example of this type of audit is the 1964-65 audit of all Army operations involving the U-1 Helicopter system including procurement, overhauls, inventory controls, general maintenance, and personnel utilization.[41]

[41]"Program Audit of the UH-1 (Iroquois) Helicopter" (Unpublished, USAAA Bulletin 365-6.1. Washington: Headquarters, U.S. Army Audit Agency, 1965), pp. 3-50.

Lateral audits. These are a second type of specific audit in which a particular procedure or system is audited in detail at all Army installations. The audit topics are also generally chosen by the Army Audit Agency with the approval of the Comptroller of the Army and the selection is based on those procedures or systems which have been found to be deficient at many installations. Lateral audits are conducted at the same time as the normal installation audits and opinions and findings are included in the installation audit report. Examples of lateral audit topics are the reporting and recording of unliquidated allotments, the military pay allotment system, and retail inventory management. In many instances combined vertical and lateral audits are conducted with the regular installation audits. Some examples of these audit subjects are military family housing assignments, Red Cross activities, and specific cost reduction programs. Audit reporting and responsibility for lateral audits and combined vertical and lateral audits follows that of installation audit reports.

Special audits. The activities of the Army Audit Agency include miscellaneous special projects requested by the Commander of a particular Army installation. These audits receive top priority and are often a form of management advice and assistance rather than audit, although, audit techniques may be used. In these projects the Agency is responsible only to the Commander requesting its services and the report goes only to this Commander. For purposes of this study these special projects are not considered auditing because they involve establishing plans, policies, or procedures rather than evaluation and because they are often not based on objective, tangible, historical evidence. Agency personnel indicated that these projects emphasize plan and policy formulation instead of critical analysis, but the Agency often sets up conditions which allow them to expand the audit scope if they feel it is necessary. Some examples of these projects are the utilization of operation research techniques to develop a formula which optimizes repair parts inventories, and the study of alternatives available for parts catalogue preparation with a recommendation of the best choice.

Each of the four types of audits conducted reflects an attempt by the Agency to utilize its audit resources in the most effective way possible. The segmentation of audit effort beyond the normal installation audits is an implicit recognition that the Agency cannot audit all phases of Army operations in a reasonable time period either at any one installation or within the total Army. Internal auditing by the Agency follows the exception principle in selection of audit subject matter, and, as shown later in this chapter, also in the basic approach to the audit examination.

The Nature of Army Audit Services

Earlier in this chapter it was stated that operational auditing by internal auditors is an expansion of their audit activity rather than an evolution since most detail financial auditing has been retained. The Army Audit Agency has taken steps to make its audits more evolutionary through refinement and improvement. These further steps led to the mission-oriented audit approach.[42] The Agency does not have sufficient manpower to audit fully all installation missions; therefore, its efforts are directed toward the major missions. In the case of Army bases, the mission-oriented audit approach emphasizes the primary mission of a base, whether it be training, support, combat readiness, etc., and, secondary missions are subject to less extensive testing. Most lateral and vertical audits deal with secondary installation missions and are a way of applying the mission-oriented approach to known or suspected weaknesses in secondary missions.[43]

Audit objectives are derived from the Army's objectives of deterring enemy aggression and standing ready to retaliate with armed might if necessary. Economy in the use of resources is of prime importance in accomplishing these objectives over an indefinite period without weakening the nation's economic structure.[44] The Agency describes its audit objective as "evaluating the adequacy of management procedures, controls, and practices as they relate to the effective and efficient use of available resources in accomplishing the major assigned missions at an installation or activity."[45] The particular audit objectives

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[42] "Mission-Oriented Audits" (Unpublished, USAAA Manual, Section 309-1. Washington: Headquarters, U.S. Army Audit Agency, 1966), p. 2.

[43] Ibid., pp. 2-3.

[44] Ibid., pp. 3-4.

[45] Ibid., pp. 4-5.

are to determine or evaluate the following factors:

1. the effectiveness of major mission accomplishment and/or the degree of readiness for future performance of assigned major missions.

2. the efficiency of operations.

3. the certainty of a continuance of adequate mission performance and/or mission readiness in an effective and efficient manner.

4. the effect and/or potential effect of deficiencies found on mission accomplishment -- both in the audited activity and in related activities.

5. the basic causes of deficiencies found.

6. the practical corrective actions that should be taken.[46]

Phases of the Audit Examination

The detail audit examination of an Army installation or function begins officially with a formal entrance conference with the audited command. This procedure eliminates the use of surprise audits. The audit officially ends with a formal exit conference at which time a draft copy of the final audit report is available and is reviewed. The three basic phases of Agency audits are preliminary planning, survey and verification, and reporting. In installation audits the time period allowed for the survey and verification phase is limited by Army regulation. The allowable number of days varies from 25 days to 180 days depending upon the size of the installation. Time elapsing between the exit conference and the issue of a final report is limited to 30 days

[46] Ibid., pp. 5-8.

and the audited installation has 60 days in which to file formal comments to the Comptroller of the Army.

Preliminary planning. This phase is described by the USAAA Manual as the gathering of basic facts for planning the audit including changes since the preceding audit and development of an audit plan in preparation for the verification phase of the audit.[47] The two basic parts of this phase are pre-audit planning and preliminary survey and review. Pre-audit planning is used "to obtain or up-date the basic information concerning the organization, operations, and procedures of the installation prior to formal entrance conference and commencement of an audit at a military installation."[48] Some of the specific objectives to be attained in this part of an audit are: (1) a review of prior audit working papers identifying possible problem areas and changes since the last audit; (2) preparation of the entrance conference format describing the major audit effort and approximate audit timing; and (3) identification of problem areas in which installation command desires extensive audit effort.[49]

The second part of this phase, preliminary survey and review,

[47]"Audit Preparatory Work" (Unpublished, USAAA Manual, Section 304-5. Washington: Headquarters, U.S. Army Audit Agency, 1965), p. 2.

[48]"Entrance and Exit Conferences" (Unpublished, USAAA Manual, Section 304-4. Washington: Headquarters, U.S. Army Audit Agency, 1965), p. 4.

[49]*Ibid.*, pp. 4-7.

is conducted to accomplish the following objectives: (1) to identify areas for audit emphasis based upon significant or indicated weaknesses in control; (2) to prepare, modify, and update audit programs to indicate the coverage required in the areas audited; and (3) to provide data for use at the entrance conference.[50] From discussions with Agency personnel, the identification of areas for audit emphasis can lead to the decision not to perform any audit tests in an area, to perform extensive audit tests in an area, or to perform only limited audit tests in an area. Secondary missions are the areas in which only limited audit testing is most likely to occur. The preliminary survey and review effectively serves the function of reducing the scope of the audit to a physically and economically possible magnitude which will still provide useful information to Army management.

The preliminary planning phase is conducted only to the extent required to gain overall familiarity and to obtain basic data. At the conclusion of this phase an audit program is developed "which sets forth the auditing techniques and procedures to be used in obtaining competent evidential matter to accomplish the objectives of the audit."[51] Audit programs are all "tailor-made" and in all audits the mission-oriented approach is followed emphasizing the primary missions of an installation. Some of the factors to be considered in preparing the audit program are Agency publications and audit guides, prior audit

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[50] "Audit Preparatory Work," op. cit., p. 3.

[51] "Preparation of Audit Programs" (Unpublished, USAAA Manual, Section 304-7. Washington: Headquarters, U.S. Army Audit Agency, 1965), p. 1.

experience, and internal and external reviews.[52] The entrance conference closes the preliminary planning phase and begins the survey and verification phase of the audit. Preliminary planning is accomplished both before visiting the audit site and at the installation. The on-site phase should be performed by the auditor in charge and lead auditors within a two week period, but this period is not included in the elapsed time limit for the audit on the rationale that this audit preparatory work is to obtain an "estimate of the situation" rather than an audit.[53]

Survey and verification. In this phase, audit evidence is collected, evaluated, and an opinion formed from this evidence. The audit scope and the audit techniques and procedures are set out in the audit program in accordance with the mission-oriented approach. The USAAA Manual lists seven major areas to be considered in evaluating the performance of primary missions assigned to an installation. These are operations, personnel, logistics, post engineer functions, other support functions, comptroller's division, and Army organizational units and supporting activities.[54] The suggested order of the audit examination is to start with operations because plans for mission priorities

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[52] Ibid., pp. 2-5.

[53] "Audit Preparatory Work: Army Commands, Installations and Activities" (Unpublished, USAAA Bulletin 304-1. Washington: Headquarters U.S. Army Audit Agency, 1963.

[54] "Guides for Auditing United States Continental Army Command Installations." (Unpublished, USAAA Manual, Section 353-1. Washington: U.S. Army Audit Agency, 1964), pp. 19-41.

originate in that office and should be evaluated early in the audit. After examining and evaluating plans for accomplishing the missions, the audit should proceed to personnel and logistics to evaluate the implementation of the plans for supporting manpower, material, and other support functions. "In the Comptroller's office, the audit should be directed toward evaluating the assistance which that office renders to the operations, personnel, and logistics divisions in carrying out the major missions of the installation."[55] As a further illustration of the direction of Agency audit effort, the Agency's Supervisors Manual indicates that in Class I installations, four factors should be considered in each of the above seven areas. These factors are installation reporting, serviceability of equipment, management of equipment resources, and personnel management.

Agency audit manuals present detailed audit guides for all classes of Army installations and for all types of primary missions. As an illustration of these audit guides, the following is a partial list of audit guides for the operations division of Class I installations:

1. determine the order of mission priorities to select the missions for primary audit emphasis.

2. select the units to be visited from the status list of all units at the installation.

3. obtain troop readiness reports, check their accuracy and evaluate the factors concerning operational readiness, possible critical MOS shortages and the steps necessary to correct shortages.

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[55] Ibid., p. 25.

4. review training plans and evaluate their effectiveness in attaining established long-range goals.

5. evaluate accomplishment of training goals, determine any deficiencies and steps being taken to correct deficiencies.[56]

Audit findings during the survey and verification phase are reported to installation personnel by "tentative statements of conditions and recommendations." This interim reporting procedure assures that all circumstances contributing to the deficiency are fully considered and that there is agreement in the facts presented and conclusions drawn from these facts. Major findings are included in the final audit report while minor findings are usually settled at the installation level. The tentative statements of conditions and recommendations report what is deficient, why it is considered to be deficient, and what is the effect of the deficiency.

Reporting. The reporting of results of audits is also formalized by Army regulations. Audit reports are prepared and submitted within a specified time period and their content and arrangement are standardized. Draft audit reports, which include a summary of the audit and statements of conditions and recommendations, are prepared at the close of the actual audit examination and are reviewed with command at the exit conference. Comments by the audited command are included in the draft report and in the final report. After the exit conference, report drafts are reviewed by the Agency's central office policy staff and legal counsel before issued in final form. The Comptroller has

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[56] *Ibid.*, pp. 23-24.

the responsibility of deciding whether to require implementation of report recommendations.

The audit reports states the purpose of the particular audit -- the mission-oriented approach -- and the auditing standards applicable. The statement on auditing standards usually refers to the use of statistical sampling and the limited detail testing of transactions. The scope of the audit is identified, because most audits do not cover all aspects of a particular installation. An overall opinion on the effectiveness and efficiency of management of the audited missions is included in the audit report and this opinion is tailored to the particular installation rather than following a standard form. Areas of major deficiencies and recommendations for improvement are listed and described in detail.

Criteria Used to Evaluate Army Audits and Auditors

Auditing standards of the Agency, as set out in its audit manual, are patterned after those of the American Institute of Certified Public Accountants and of the Institute of Internal Auditors. The three categories of official auditing standards are general standards, standards of field work, and standards of reporting. General or personal standards include adequate training and proficiency in Army Audit operations, independence and objectivity, and due professional care.[57] Standards of field work include planning and supervision, evaluation of

[57] "Personal or General Standards." (Unpublished, USAAA Manual, Section 302-2. Washington: Headquarters, U.S. Army Audit Agency, 1966), pp. 1-4.

the management control system, and collection of adequate, relevant, factual evidence. Some of the appropriate audit techniques identified in field work standards are inspection, observation, confirmation, interrogation, and tests of policies and practices to support audit findings and opinions. Evidence is to be clear, conclusive, relevant, representative, and convincing; the cost of obtaining additional evidence should be equated against benefits derived from additional audit work.[58] Standards of reporting include both the requirements for technical compliance with regulations and the requirements of clear and concise presentation of audit results. Audit reports are advisory and should in the communication of audit results, in the tone of audit reports, in selecting the level of management to which reports are directed, and in the disclosure of managerially useful data, result in the most effective assistance to management.[59] In this respect, recommended changes in Army policies are not included in audit reports but are communicated directly to the appropriate Department of the Army staff office by correspondence.

Since the Agency assumes no direct responsibility to third parties, the main criteria by which audits are judged is that of usefulness to top management of the Army and to the command level audited.

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[58] "Standards of Field Work." (Unpublished, USAAA Manual, Section 302-3, Washington: Headquarters, U.S. Army Audit Agency, 1966), pp. 1-6.

[59] "Standards of Reporting." (Unpublished, USAAA Manual, Section 302-4. Washington: Headquarters, U.S. Army Audit Agency, 1966), pp. 1-4.

From this point of view, the official standards described above are the Agency's own interpretation of the factors necessary to insure useful audits. Top management and audited commands measure usefulness by the improvements in the effectiveness and efficiency of Army operations brought about by Agency efforts rather than by the Agency's adherence to a prescribed set of standards. The measure of audit usefulness in terms of dollar savings is important in Agency audits but not to the same degree as in internal audits in private business and in audits by the General Accounting Office. However, the simplest way to justify the application of resources to audit efforts is through the computation and reporting of dollar savings. Projected dollar savings from management audits by the Agency have become more important since the separation of contract auditing and Army auditing in 1965.[60]

Criteria Used by the Army Audit Agency to Interpret Audit Evidence

In the earlier part of this chapter and in the following chapter on General Accounting Office audits, criteria used to interpret audit evidence are presented and analyzed by listing some of the deficiencies found in audit reports. Unfortunately this approach cannot be used in the analysis of criteria used by the Army Audit Agency. Army deficiencies reported by the audit agency often directly affect national defense

[60]"Reporting Dollar Savings Based on USAAA Audit Services," (Unpublished, USAAA Manual, Section 306-18. Washington: Headquarters, U.S. Army Audit Agency, 1965), p. 1.

or military readiness and, therefore, are not public information. The alternative sources of information used in this section are discussions with Agency audit personnel, specific audit guidelines in Agency bulletins, and the general aspects of audit reports.

Agency audit personnel indicated that there are four basic types of standards used to interpret evidence collected during an audit and to form an opinion thereon. These four types of standards are:

1. Laws and Regulations -- These criteria include the mandatory operating policies and procedures prescribed by Congress or top level Army staff. Some civil laws are applicable, but this category deals mainly with Army regulations.

2. Policies, Procedures, and Standards Established by the Command of an Installation -- These criteria are set up by management itself to judge its success or to insure successful operations. For example, the Agency compares actual time needed to distribute supplies and repair parts with standards set by the command.

3. Generally Recognized Good Management Practices -- In this category, management's plans, policies, and activities are compared to generally recognized good practices. These criteria are based upon logical approaches to the best possible operations and are usually supported by examples.

4. Criteria Created by the Army Audit Agency -- This type of standard is frequently used by the Agency to interpret the other three types of standards. For example, the Agency's decision of what percentage of Army personnel assignment by primary skills constitutes effective personnel utilization is based on this type of standard.

To complete this analysis of criteria used to interpret audit evidence, the criteria used by the Agency are classified by the five general categories of management standards developed in Chapter IV: social, economic, legal, controlling interests, and reasonable managerial skill.

Social criteria used by the Army Audit Agency. The Army is a public agency and all of its operations in national defense, military readiness, etc. are important to the general public; therefore, all audit findings must be judged by general social standards. The effectiveness and efficiency of Army policies, plans, and activities are judged by social standards as interpreted by Agency auditors. However, in actual practice, most social standards used are those interpreted by existing Army regulations and can be classified as legal standards or standards of controlling interests. Some examples of Agency use of social standards not already recognized by regulations are: (1) the importance of effective personnel utilization to justify increasing draft calls which is used to judge installations' effectiveness in assigning enlisted personnel by primary skills, (2) improved military readiness based upon the effective and efficient operations of a particular military defense system, and (3) the importance of troop morale for operating efficiency and public opinion is used to judge findings in payroll accuracy and timing.

Economic criteria used by the Army Audit Agency. By defining economics as the allocation of scarce resources among unlimited needs, all audit measures of the efficiency of Army operations use economic criteria. The importance of economic considerations is recognized by the Agency in establishing the justification of their audits, "economy in the use of resources is essential if we (United States) are to remain for an indefinite period a strong military force. . . ."[61] The

[61] "Mission-Oriented Audits," p. 4.

significant feature of the Agency's use of economic criteria to judge audit evidence is that this criterion is not limited to dollar measures of resource utilization. The economic efficiency of personnel utilization and facility utilization are considered as well as the utilization of appropriated funds. Some examples of the use of economic criteria to interpret audit findings are: (1) the elimination of unnecessary facilities resulting in a duplication of effort; (2) inefficient operations due to excessive delays in installing electronic data processing equipment; (3) uneconomical accumulation of excess perishable supplies; and (4) inefficient utilization of enlisted men based on primary MOS code rating.

Legal and controlling interest criteria used by the Army Audit Agency. Laws applicable to Army operations are implemented through Army regulations, and, in this sense, legal responsibilities and responsibilities to the controlling interests of top Army staff are the same. The Army is subject to other laws, but no evidence of the use of legal criteria other than Army regulations was found in this investigation. Laws and regulations are the most important criteria used by the Agency to interpret audit evidence, and Agency audit personnel indicated that the use of regulations as judgment criteria can be found in almost all audit reports. Some of the findings reported are: (1) failure to follow prescribed regulations in reporting equipment condition based upon unrecorded mechanical weaknesses; (2) failure to follow regulations in the assignment of personnel; (3) cost records not prepared in accordance with requirements of the accounting manual, and (4) failure to follow prescribed procedures for the rotation of old and new equipment. This type of criteria is often listed in the audit guides for particular types of Agency audits. For example, one bulletin lists four factors to consider in a vertical audit of personnel management of which the first is "compliance with the Army priority system in distributing/assigning personnel."[62]

<u>Criteria of reasonable management skill used by the Army Audit Agency.</u> The requirement of reasonable skill in the management of Army operations is the basis for three of the four types of criteria used by Agency audit personnel as listed on page 143 of this chapter -- management's self-imposed standards, general standards of good management, and Agency created standards. Agency audit personnel stated that their primary objective is not to criticize management but, in order to assist management, deficient practices are reported and improvements suggested. Most major findings deal with management at the installation command level and some examples are: (1) the absence of standard operating procedures for day to day guidance of operating areas; (2) inadequate policies for training new clerical employees; (3) lack of management control over supplies; (4) poor control over the accumulation of troop strength data resulting in under supply or over staffing; and (5) inadequate procedures for cost control.

Basic guides to Agency management audits emphasize the evaluation of the controls developed and used by management. In its audits of Army tactical units, the Agency recognizes its lack of technical knowledge

[62]"Vertical Audit of Enlisted Personnel Management," (Unpublished USAAA Bulletin 312-1. Washington: Headquarters. U. S. Army Audit Agency, 1965), p. 7.

but maintains that it can audit the effectiveness and efficiency of a mission's activities and the impact of management controls on military capabilities.[63]

Each audit report includes an overall opinion on the management of the audited installation, system, or mission. These opinions are based on audit evidence and use the criteria necessary to evaluate management's skill. Specific audit report cannot be cited for security reasons, but some examples of the basic form of these opinions are as follows:

> Based on our examination we conclude that over all programming, budgeting, supply, and property management were generally satisfactory.
>
> In our opinion the project system audited was managed in a generally effective manner by the project manager and his staff. The effectiveness of the project manager's direction and control, however, can be enhanced by further improvements in. . . .
>
> Based on the results of audit, there was generally effective management of Federal resources made available.
>
> Accomplishments inthe basic area were especially commendable. Although there were still shortages in certain aspects.
>
> It is our opinion, however, that a more effective utilization of resources applied to each function could have been attained. For example. . . .

The opinion is followed by a description of major or minor deficiencies, if any, and recommended improvements. The opinion is preceded by statements on the major area of audit emphasis, the type of audit evidence used, and the limitations of the audit scope. When more than one primary mission is included in the audit scope or when lateral and installation audits

[63]"Operational Auditing as Applied to Tactical Units," (Unpublished, USAAA Manual, Section 353-2. Washington: Headquarters, U.S. Army Audit Agency, 1963), pp. 2-4.

are combined, separate opinions on each area of audit effort may be reported.

Summary of Management Audits by the Army Audit Agency

Management audits by the Army Audit Agency cover the full range of managements' plans, policies, and activities. The Agency is responsible directly to top management of the Army -- the Comptroller -- and only indirectly to the public through Congress. Agency audit reports are not made public. Audit results may also be useful to the audited command, but the Agency's responsibility to the audited command is indirect through the Comptroller. The audit subject matter of the Agency can be any aspect of Army operations, but for practical reasons audits emphasize only major missions. Within the bounds of these missions, policies, procedures, and operations are subject to audit examination.

As in internal auditing, audits are conducted on the exception principle in which the scope of detail audits is progressively narrowed until concentration is upon some specific problem area. The audit service includes collection of evidence, evaluation of evidence, making recommendations for improvement, and rendering an opinion. The Army Audit Agency is one of the few management audit groups that gives an opinion directly evaluating management. Army auditors and their audits are judged by uniform standards which are patterned from those of the American Institute of Certified Public Accountants. However, the ultimate criteria used are those of useful results.

When compared to the concept of management auditing derived from the theory of criticism in Chapter III, the scope of the Agency's audit activities fall somewhere between a narrow scope which is accurate but of limited usefulness and a broad scope which is useful but too subjective to be very accurate. The mission-oriented audit approach follows this standard of reasonable usefulness with reasonable accuracy. The scope of the audit evaluation is reported and the criteria used are enumerated to meet the requirements of valid criticism described earlier in Chapter III. The Agency uses audit methodology in the collection and interpretation of evidence, but the audit approach depends upon audit objectives rather than being limited by available audit procedures.

Compliance with prescribed policies and regulations are the primary criteria used by the Agency to evaluate audit evidence. In terms of the categories set up in Chapter IV, most of these criteria would be classified as those set by controlling interests. Rules and regulations are in effect the Army's interpretation of social, economic, and legal standards. Standards of reasonable managerial skill are used in evaluating compliance with rules and regulations. The Agency usually identifies the criteria used in reaching an unfavorable opinion.

Requirements for successful management audits by the Army Audit Agency. Some of the more important reasons for the development of management auditing in the Army and for its successful application are listed below:

1. the absence of profit as a measure of the success of operations.

2. an attitude of social responsibility for the effective and efficient application of resources and an acceptance, by both top management and lower management, of the philosophy that management activities are subject to audit.

3. the existance of a structured organization with well defined duties and responsibilities at all levels of both management and operation activities.

4. the development, use, and acceptance of an audit approach which is useful but not all-inclusive in scope -- the mission-oriented audit.

5. the audit scope is narrowed to a specific problem which is identifiable and for which specific objectives and programs can be developed and criteria identified.

6. the audit examination and audit findings are conducted with the audited parties' cooperation and full understanding; no surprise audits or confidential findings.

Limitations of management audits by the Army Audit Agency. The following list includes some of the more important factors which limit the effectiveness of the Agency's audits as determined by the foregoing investigation of Army Audit Agency's activities:

1. audit subjects are limited to those approved by the Comptroller of the Army.

2. audits emphasize compliance with the existing establishment and its regulations rather than the propriety of the regulations.

3. audit reports are not made public.

4. audits are not of sufficient breadth to permit general evaluation; such audits are not economically feasible.

5. audits are often limited by time rather than findings and the emphasis is upon deficiencies.

6. the Agency must often create and define its own criteria by which findings are evaluated.

The requirements and limitations of management auditing set out in this chapter and in subsequent chapters are summarized and conclusions and recommendations are presented in Chapter IX of this study.

CHAPTER VI

MANAGEMENT AUDITS BY THE GENERAL ACCOUNTING OFFICE

The purpose of this chapter is to investigate the "comprehensive audit" conducted by the General Accounting Office and to illustrate the relationship between the GAO's audit client, scope, responsibility, services, and the criteria used to draw conclusions from comprehensive audit evidence. Some criteria actually used in this type of auditing are listed to illustrate one approach employed to develop and apply management auditing criteria.

A more detailed analysis of specific audit activities is needed to support the broad definition of auditing, which includes management auditing, used in this study, and to define the role of management auditing in the general body of auditing theory and practice. This chapter supports the assumption that criteria for drawing conclusions about audit evidence obtained in some types of management auditing do exist and it aids in the understanding of the nature of such audit criteria. The investigation of the type, nature, and quality of management audits currently practiced is necessary for any conclusion as to whom, if anyone, is best qualified to conduct these audits.

The approach used in this chapter is to briefly review the historical background of auditing by the General Accounting Office and the current status of its management auditing -- known as comprehensive auditing. This review is followed by a descriptive analysis of the nature of the comprehensive audit client, audit responsibilities, and audit services. Official audit reports, "on the job" audit manuals, instructions, programs, and other materials are used as sources to provide information about the nature of comprehensive auditing and to identify the criteria by which audit evidence is interpreted and audit opinions reached.

Historical Background of Auditing in the Government and Auditing by the General Accounting Office

Evidences of auditing can be found as far back in history as the days of ancient Egypt and records of government auditing in early English history are numerous. There is evidence that as early as 1298 the reports of the Chamberlain of the City of London were audited by a committee of aldermen, sheriffs and the mayor.[1] The British Parliament Acts, in 1491, provided for a yearly "inquisition" into expenditures of government activities for the "common good."[2] The early English Auditor of Imprest was an unsuccessful attempt to promote government efficiency and accuracy, but it is significant that the office was replaced by a Board of Commissioners with similar duties rather than abolished. It can be reasoned that the successful use of government auditing to control government operations for the "common good" led to

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[1] A. C. Littleton and V. K. Zimmerman, Accounting Theory: Continuity and Change (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1962), p. 103.

[2] Richard Brown, A History of Acoounting and Accountants (Edinburgh: T. C. & E. C. Jack, 1905), p. 81.

the audit requirements of the early English Companies Acts controlling private companies which assumed public responsibility.

Early English auditing is usually cited as evidence of the first developments of professional auditing by public accountants; however, this auditing is also evidence of the early development of internal auditing and governmental auditing. Since government auditing deals with a "captive client" who is not audited by his choice, such audits need not be immediately justified in the economic market and may go beyond those practices proven to be economically feasible. The English Manor System was basically a government system and the historical precedent for government audit practices to be the forerunner of new developments in the general field of auditing may be applicable at the present time.

Early Government Auditing in the United States and the Formation of the General Accounting Office

An act of the First Congress of the United States, in 1789, provided for a public official described as an auditor. The auditor's duties were to receive all public accounts, examine them, certify the balances and transmit them with vouchers and certificates to the Comptroller for his decision thereon.[3] This centralized voucher audit continued to be the main function of Federal Government auditors until the mid-1940's. The Federal Government audit duty was vested in the

[3] C. Aubrey Smith, Internal Audit Control (Austin, Texas: The University Co-operative Society, 1935), pp. 198-99.

executive branch from 1798 until 1921, at which time it was transferred to the legislative branch.[4]

The General Accounting Office was created by the Budget and Accounting Act of 1921 and was placed in the legislative branch of the Government. Some of the more important provisions of this act are:

1. the Comptroller General is empowered to investigate all matters relating to the receipt, disbursement and application of public funds.

2. the Comptroller General is to make an annual report to Congress in writing which reports his work and recommendations for improvement.

3. the Comptroller General shall make any special investigations ordered by Congress.

4. the Comptroller General shall report upon the adequacy and effectiveness of the administrative examination of accounts in government departments and establishments and actions of government fiscal officers.

5. all governmental departments and establishments shall furnish the Comptroller General with such information concerning powers, duties, activities, organizations, financial transactions and methods of business as he shall require and he shall have access to all records, documents, etc. necessary for his examination.[5]

This 1921 act and subsequent acts give the Office broad powers to investigate all matters relating to the receipt, disbursement, and application of public funds and to make recommendations for improving the economy and efficiency of government operations. The 1921 Budget

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[4]United States General Accounting Office, Accounting and Auditing Developments in the United States General Accounting Office (U.S. Government Printing Office, Washington: 1957), pp. 3-4.

[5]Comptroller General of the United States, 1964 Annual Report (Washington: U.S. Government Printing Office, 1964), pp. 450-51.

and Accounting Act is cited in all current audit reports as the authority to conduct audits and report thereon.

Auditing Developments by the General Accounting Office in the 1940's and 1950's

The Office continually expanded its audit work after 1921 and since World War II it has de-emphasized the traditional centralized voucher audit. Congressional Acts of 1945 and 1949 re-emphasized the GAO's responsibility to the legislative branch of government and, in a 1950 act, the Comptroller General was designated an agent of Congress.[6] The Government Corporation Control Act of 1945 required the General Accounting Office to conduct "independent," "professional" financial statement audits of the Federal Corporations. The successful accomplishment of these audits is credited with causing the extension of similar types of audits to other government agencies.[7] The various Acts of Congress set out other duties, such as the establishment of government accounting systems and the settlement of government claims, but only those duties related to auditing are considered in this investigation.

The concept of a comprehensive audit began to appear soon after corporation financial types of audits were used in government agencies. The following passage from a GAO publication of 1957 explains this

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[6] Robert B. Lewis, Editor-In-Charge, "General Accounting Office, Background, Organization and Functions," The Federal Accountant, V. XIV, No. 4 (Summer, 1965), pp. 116-118.

[7] United States General Accounting Office, op. cit., pp. 7-9.

development:

> It soon became apparent that the scope of the corporation audits needed expansion, if we were to fully discharge our audit responsibilities in the agencies and produce the proper reports for the Congress. These expanded audits in the agencies are called "comprehensive audits." In 1949 the Comptroller General announced the comprehensive audit program as the basic audit policy of the office. The Accounting and Auditing Act of 1950 gave official recognition to this policy by incorporating its basic principles into legislation.[8]

The 1950 Accounting and Auditing Act is cited in all audit reports, except normal corporate financial audits, as its authority for conducting comprehensive audits and reporting thereon.

Current Status of Comprehensive Auditing by the General Accounting Office

The Accounting and Auditing Division of the Office is engaged in audits and investigations into the manner in which Government agencies discharge their financial responsibilities. Agencies' financial responsibilities are defined as, "the expenditure of funds and the utilization of personnel in the furtherance only of authorized programs or activities and the conduct of programs or activities in an effective, efficient and economical manner."[9] Comprehensive audits emphasize both the aspects of agency operations which are suspect or found to require correction or improvement and the means of accomplishing improvements. The GAO's Comprehensive Audit Manual states that, "the effective

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[8] Ibid., p. 9.

[9] Lewis, op. cit., p. 125.

carrying out of our audit responsibilities requires the prompt reporting of audit findings and related recommendations to the Congress. . . ."[10]

Comprehensive audits are not intended to lead to reports on the effectiveness or efficiency of total government operations, nor on the total operations of any one government agency. Rather, the examinations and reports are directed toward specific activity or program areas of an agency or department. The Office's audit manual describes the direction of its audit effort as follows:

> The breadth and depth of our Governmental audit interest and responsibility in relation to our resources require the most efficient utilization of available staff. . . . Except as otherwise required by statute, external request, or other factors beyond our control, our basic audit policy is to direct available resources and talents to the areas in which they can be most effectively used to fulfil the greatest apparent need and benefit to the Government.[11]

In 1964 testimony before a House Committee, the Comptroller General presented the basic audit philosophy as application of its manpower resources to those aspects of agency operations with management weaknesses as evidenced by unnecessary waste, losses, and expenditures, and to report all significant findings.[12]

The current status of comprehensive auditing by the General Accounting Office is dynamic rather than static and the expanding scope of auditable subject matter ranges from reporting unsafe working conditions in General Service Administration storage areas to reporting

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[10]United States General Accounting Office, "Comprehensive Audit Manual, Volume I" (Unpublished), p. 2-1.

[11]Ibid., p. 2-2.

[12]Lewis, op. cit., p. 128.

errors in pricing government contracts. The expansion of audits has not been without some objections. Recent critics have claimed that, by evaluating managements' decisions after the fact, the GAO leaves an undue stigma of "bumbling managment." In reply the Comptroller General stated that the Office tries to carry out its responsibilities to the best of its ability in a fair and impartial manner and that he does not see how the unfavorable reflection upon the agency or contractor under audit can be avoided if the General Accounting Office carries out its duties as Congress intends.[13] The broad interpretation of audit responsibilities by the General Accounting Office includes any examination or review of an activity after the fact which will provide information for a report on the effectiveness and efficiency of the use of public funds.

Audit Responsibilities of the General Accounting Office

Comprehensive auditing, like any other type of auditing, can be described in terms of the responsibility to users of audit results. Auditors are directly or indirectly responsible to all audit report users and, as the first step in the analysis of comprehensive auditing, the pattern of this responsibility is investigated. The General Accounting Office is an agency of Congress and directly responsible only to Congress; however, indirect responsibility covers a broad range of report users.

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[13] The Journal of Accountancy, V. 120, No. 2 (August, 1965), pp. 9-10.

The order used in this description of responsibilities to users of audit results does not necessarily represent a ranking in the degree of audit responsibility. It generally represents the relative size of audit user groups and the relative diversity of usages. This description of audit responsibilities also includes some consideration of the various types of audits conducted by the General Accounting Office which are covered in more detail later in this chapter.

Responsibility to the Public

As an agency of the Federal Government, the General Accounting Office is indirectly responsible to the general public. The Comptroller General is appointed by the President with the advice and consent of the Senate and the agency itself is an arm of Congress. Audit reports to Congress are public documents, and are used by the general public. The major wire services have a standing order for a copy of all GAO reports to Congress to make this information available to the public through associated newspapers. The exercise of control over audit activities by the general public is indirect by way of elected congressional representatives, but general congressional interests, as they express public opinion, can affect audits by the General Accounting Office. Generally the nature of comprehensive audit investigations and reports on governmental deficiencies lead to public interest, public usage of audit reports, and, therefore, public responsibility.

Responsibility to Congress

The General Accounting Office's basic audit responsibility to Congress comes from the 1921 Budget and Accounting Act of which Section 312 states:

> The Comptroller General shall investigate, at the seat of government or elsewhere, all matters relating to the receipt, disbursement, and application of public funds, and shall make to the President when requested by him, and to Congress at the beginning of each regular session, a report in writing of the work of the General Accounting Office . . . . In such regular reports, or in special reports at any time when Congress is in session, he shall make recommendations looking to greater economy or efficiency in public expenditures.
>
> . . . .
>
> He shall submit to Congress reports upon the adequacy and effectiveness of the administration of accounts and claims in the respective departments and establishments. . . . [14]

The GAO's audit manual describes the General Accounting Office as a nonpolitical, nonpartisan agency created by Congress to act in its behalf in examining the manner in which executive agencies discharge their financial responsibilities with regard to public funds made available to them by Congress and in recommending ways of improving the efficiency and economy of public expenditures.[15] The majority of the final audit reports go to both Houses of Congress and are formally addressed to the President of the Senate and the Speaker of the House of Representatives. In the fiscal year 1965, 245 such reports were made to Congress.

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[14] United States General Accounting Office, "Comprehensive Audit Manual, Volume I" (Unpublished), pp. 1-1 and 1-2.

[15] United States General Accounting Office, "Comprehensive Audit Manual, Volume II" (Unpublished), p. 1-2.

The GAO is also required to make any investigation ordered by either House of Congress or any Committee dealing with revenue, appropriation, or expenditure.[16] In actual practice audits are performed by request of any Committee of Congress and reports are made directly to that Committee or to Congress as a whole. Although any audit authorized by the various acts may be performed, in actual practice, those audit topics which are not of current interest to Congress do not reach the report stage. The GAO looks to Congress for its authority to operate and for its operating funds; therefore, audits tend to be tailored by current congressional interest.

Responsibility to Individual Congressmen

The General Accounting Office is responsible to individual congressmen -- Representatives and Senators -- because these individuals control the actions of Congress as a whole and more importantly because the GAO acts as a special investigating agency for congressmen. These special investigations are described in more detail later in this chapter as one type of comprehensive audit. The reports, which are a result of these investigations, are in the form of a private letter to the requesting congressman. The reports are the private property of the congressman and, as such, may not necessarily be publicly circulated. The direct responsibility for these reports is to the congressman who has requested the investigation. From discussion with GAO personnel, it appears that these special investigations receive top priority in

[16] *Ibid.*, p. 1-16.

scheduling and assignment of auditors.

Responsibility to Executive Agencies

Comprehensive audit reports are directed to cabinet level departments, to top agency officials, or to local department and agency officials when the audit findings and the recommendations are not considered significant enough for a report to Congress. Some audits, such as payroll audits, are of such a nature that reports are submitted to local agency officials regardless of the audit findings.[17] In these audits, the General Accounting Office is responsible to department and agency officials for accurate and useful reports. Operating policies require a discussion of audit findings with appropriate agency officials when any apparent deficiencies are found.[18] Written communications and other agency comments concerning either disagreements with audit findings or corrections made are included in many audit reports to Congress. The GAO's basic responsibility to executive agencies and departments is to maintain an objective approach to any deficiencies found and to provide equitable treatment to agency views.

Responsibility to Government Contractors

The General Accounting Office frequently audits the cost records

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[17] United States General Accounting Office, "Comprehensive Audit Manual, Volume I" (Unpublished), p. 6-2.

[18] Ibid., p. 8-25.

of Government contractors to detect any over-charges to the Government. This type of audit will be considered in more detail later in this chapter. The audit authority in these investigations is regarded as an extension of the audit of a Government contracting agency and the audit findings usually deal with inadequate contract cost reviews by the Government agency and possible refund claims against the contractor. The audit responsibility to contractors is similar to the responsibility to agencies; that is, to discuss audit findings with appropriate officials of the contractor and to include the contractor's comments in the audit report.[19] The GAO is not responsible for obtaining refunds, but is responsible for making recommendations to the appropriate Government agency. Discussion with GAO personnel indicates they feel they are responsible for a reasonable approach to contract audits because these audits usually affect major industrial companies whose opinions can affect congressional attitudes toward GAO operations. The responsibility is for reports which are fair and equitable to both the contractor and the Government agency involved.

Internal Organizational Responsibilities

The General Accounting Office, like other auditing organizations, has a system of internal organizational responsibilities. The organization of the Office was set up with advice from the larger CPA firms and

[19] United States General Accounting Office, "Comprehensive Audit Manual, Volume VII," p. 1-7. (Unpublished)

follows a pattern like that of a CPA firm in which the junior auditor is responsible to a senior, the senior to a manager; the manager to a regional director and the regional director to the Washington office. Audit reports are issued by either a regional director of the Comptroller General; however, all reports are cleared through the central office in Washington, D.C. All audit reports are reviewed by the Accounting and Audit Policy Staff, the General Legal Council and the Comptroller General's staff.[20] The internal responsibility is met through a system of numerous checks and reviews before accepting external responsibility by reporting audit results.

Subject Matter of Audits by the General Accounting Office

The GAO is charged with the specific responsibility of auditing Federal agencies and in practice this responsibility has been extended to include the audit of any area of Government operations which will improve the effectiveness and efficiency of the use of public funds. Comprehensive audits of agencies are called civil audits; comprehensive audits of Government contractors are called contract audits; and comprehensive audits of other areas requested by Congress are referred to as special investigations.

Comprehensive Civil Audits

The laws providing authority to audit Federal agencies do not

[20]Ibid., pp. 3-4 to 3-7.

establish the required frequency of audit nor do they identify specific agency activities to be audited. Certain Federal activities are excepted from audit review, for example the Federal Reserve Board, Federal Reserve Banks, the Comptroller of Currency, tax return files of the Internal Revenue Service, treaty expenditures of the Department of State, the White House Office, the Central Intelligence Agency, the Federal Bureau of Investigation and others of a similar confidential nature are not audited.[21] In all other Government agency activities the GAO's official policy for directing audit effort is "to direct available resources and talents to the areas in which they can be most effectively used to fulfill the greatest apparent need and benefit to the Government."[22] Detail description of the steps taken to select the particular activity within an agency will be considered later in this chapter. From discussion with personnel of the General Accounting Office, it appears that the general selection of the agency, and the activity within that agency, to be audited is based upon: (1) an attempt to audit all subject agencies on a reasonably regular basis; (2) knowledge of current areas of interest to Congress and specific congressional requests, (3) audit findings in one area which indicate the possibility of similar deficiencies in other agencies or in other areas; (4) attempts to review new congressional programs early to identify possible future trouble areas; and (5) other ideas by audit personnel. With the exception of those areas excepted by law,

[21] United States General Accounting Office, "Comprehensive Audit Manual, Volume I" (Unpublished), pp. 14-3 and 14-4.

[22] Ibid., p. 2-2.

comprehensive audits are directed at all levels of Federal agency activities.

Comprehensive Contract Audits

In connection with reviews of Federal agencies which negotiate and administer contracts, the General Accounting Office audits negotiated contracts at contractors' and subcontractors' plants. The Federal Property and Administrative Service Act of 1949, as amended, provides that:

> All contracts negotiated without advertising pursuant to authority contained in this Act shall include a clause to the effect that the Comptroller General of the United States or any of his duly authorized representatives shall until the expiration of three years after final payment have access to and the right to examine any directly pertinent books, documents, papers, and records of the contractor or any of his subcontractors engaged in the performance of and involving transactions related to such contracts or subcontracts.[23]

In fulfillment of this act, a substantial portion of the subject matter of comprehensive audits consists of the records of Government contractors concerned with costs charged the Federal Government. The selection of the contractors to be audited, in actual practice, is similar to that of civil audits, and the approach used in these audits is described in more detail later in this chapter. The GAO is also authorized to audit the records of recipients of Federal financial assistance. These audits are similar to contract audits when applied to grants to institutions for specific projects and they are similar to civil audits when applied to

[23] Ibid., p. 14-3.

grants to operating state agencies such as State Employment Agencies.

Special Investigations

These investigations are the result of special assignments by individual congressmen or congressional committees and the audit subject matter is specified in the assignment. However, the General Accounting Office is free to determine the scope and extent of audit work done, the approach used, and the type of report issued.[24]

Since these investigations are of a confidential nature, they cannot be included in this study. Discussions with GAO personnel revealed that these investigations treat a wide range of financial and non-financial Government activities. Also, any request for an investigation for which the report may have political overtones is either refused, delayed until after an election, or, if significant, treated as a civil or contract audit. In investigations which are of political significance, the General Accounting Office considers itself primarily responsible to Congress as a body and secondarily responsible to individual congressmen.

Comprehensive Audit Services of the General Accounting Office

This section considers the general audit approach and the specific audit procedures used in a comprehensive audit examination. This description is in more detail than is indicated in general statements of official policy such as, "examining the manner in which Government

[24] *Ibid.*, p. 15-1.

agencies discharge their financial responsibilities." The factors to be considered are: the general approach to comprehensive audits; the audit work done in each phase of a comprehensive audit; and the limitations of the comprehensive audit.

Basic Approach to Comprehensive Auditing

The instructions to audit personnel list six basic principles which underlie the nature of their comprehensive audit work. Briefly these principles are:

1. audits are analytical and critical examinations of agencies and their activities and are not restricted to accounting matters or to books, records and documents.

2. audits emphasize known or suspected weaknesses such as ineffectiveness, inefficiency, waste and extravagance, failure to comply with laws, etc.; however, reports should be balanced by recognizing favorable findings.

3. the technical nature of an operation does not remove it from the scope of audit. Technical advice may be used when needed.

4. the starting point in the review of any operation is to find out how the agency itself performs the operation.

5. good accounting records are not a prerequisite for an audit and the discharge of management's accounting function is subject to audit review.

6. audits disclose improper transactions but more importantly individual transactions are to be used to demonstrate faulty practices and to promote constructive suggestions.[25]

In applying these audit principles it is impractical, except in the smallest agencies, to review all important activities of an agency at the same

[25] Ibid., pp. 2-7 and 2-8.

time. Since the GAO feels the most important part of its audit work is to develop specific information about an operating activity which is of concern to appropriate officials, it intentionally concentrates audit work on the investigation of deficiencies rather than on general evaluations.[26]

General comprehensive audit objectives include factors such as whether the agency is conducting only those activities or programs authorized by Congress, whether the programs still serve the original intended purpose, whether the programs are effectively and efficiently administered in accordance with applicable laws and regulations, whether resources are effectively and efficiently utilized and properly accounted for, and whether adequate reports are prepared.[27] Since the complete attainment of the general objectives in any one audit assignment is seldom possible a set of specific objectives for a particular audit examination is established. These specific objectives must be attainable and be within the framework of the general objectives.

Some of the factors considered in reaching a decision on the nature, direction, and intensity of audit effort are: (1) statutory audit requirements, (2) congressional interests and requests, (3) potential significant adverse findings, (4) importance of an activity, and (5) capacity to develop findings into a useful report. The specific area of audit inquiry is chosen by the GAO and one basis for the choice is that which will result in a significant audit accomplishment. There are

[26]*Ibid.*, p. 8-1.

[27]*Ibid.*, pp. 2-1 and 2-2.

three types of audit accomplishments that should result from a comprehensive audit:

> 1. Improvements -- Changes in methods, procedures, or operations which result in greater efficiency or economy . . . .
>
> 2. Collections -- Recoveries of money erroneously or imprudently paid out. . . .
>
> 3. Prevention of improper or unnecessary expenditures -- Dollar amounts which would have been erroneously or imprudently paid out had we not called attention to the matter.[28]

After the agency or contractor to be audited has been selected, the GAO selects the particular activity to be examined and establishes the specific audit objectives. The phases of the audit examination, as described below, further narrow the scope of the audit subject matter. The basic approach to comprehensive auditing is to emphasize specific audit findings, and in practice, these are usually adverse findings. Since almost all adverse findings are contested by the auditee, comprehensive audits tend to report only those findings which can be factually supported and, in the case of contractors, only those findings in which there was "prior knowledge" of erroneous costs.

Phases of Comprehensive Audit Examinations

The detail comprehensive audit examination of an activity or operation is conducted in three phases: the preliminary survey, the preliminary review, and the detail examination. While in actual practice it is difficult to tell when one phase ends and another begins,

[28] Ibid., pp. 17-17 and 17-18.

the objectives of each phase are different. The purpose of the three phase approach is to narrow the subject matter of the audit examination to the point where specific, factually supported, reportable audit findings can be developed.

Preliminary survey phase of comprehensive audits. This phase is the first approach to the audit of an agency, contractor, or activity. Official policy describes this phase as:

> Obtaining general working information on the agency or activity component under audit for use and reference in conducting the audit and as a general basis for planning the specific work to be done.[29]

Audit personnel described audits at this phase as consisting of a "tentative audit case with indefinite potential." During this survey, auditors collect considerable data at random in an effort to pinpoint a major problem area, if any exist.

The general subject matter for a preliminary survey includes: applicable laws, regulations and contracts; history of the agency; organization structure; nature of dollar investment; financial system and information; general policies; operating methods; and any unsolved problems.[30] The auditor obtains a working knowledge of important aspects in as short a time as possible. Usually more experienced auditors conduct this phase and a preliminary survey may take from three to five months to complete. A preliminary survey may not lead

[29] Ibid., p. 2-4.

[30] Ibid., pp. 4-2 to 4-4.

to a detail audit and any audit examination halted at this stage results in a memorandum to file summarizing the work done and the reason for stopping the examination. Since these surveys are not public information, none of the "closed-out" files were reviewed for this study.

Preliminary review phase of comprehensive audits. In this audit phase the auditors obtain practical working information on how an agency's systems and procedures in a specific area actually work and how effective they are. Possible weaknesses needing further examination are identified. A major part of this audit phase is the review of management controls. The objectives of the review of management controls include determining whether the policies, procedures, and practices followed comply with statutory requirements; whether the system of procedures and controls results in efficient and economic operations conducted in accordance with top management's policies; and whether the system provides satisfactory control over costs, receipts, resources, etc.[31]

The preliminary review serves the function of selecting the subject matter to be examined in the detail audit. It further narrows the audit subject matter and usually develops a "firm problem case." To accomplish this concentration of audit subject matter, a number of specific transactions in the problem areas are examined. General Accounting Office audit personnel describe this phase as the development of two or three aspects of the major problem, identified

[31] Ibid., p. 6-3.

in the preliminary survey, to find one substantial point which can be developed and reported. Detail audit programs, often based on a sample case, are prepared at the close of this review phase to be used in the detail examination. This phase may take up to three months to complete and is usually combined with the beginning of the detail examination. Audits are seldom closed out at the end of the preliminary review phase; however, the findings of this phase often control the decision on the level of report to be prepared.

Detail examination phase of comprehensive audits. Detail examination procedures are the means of attaining the audit objectives established for a particular assignment. The audit program, developed in the preliminary review, specifies the audit subject matter, the type and quantity of evidence to be collected, the type of finding to be developed, and the nature of the audit report to be prepared.

Since the scope of the audit is established in the first two phases, the detail examination is primarily the collection of audit evidence from which opinions and conclusions can be reached and recommendations developed. The basic types of evidence collected are physical, documentary, testimonial, and analytical. The GAO's audit manual describes the collection of evidence in the detail examination as including:

> . . . such operations as inspecting records and files, and analyzing, checking, verifying and confirming the information contained in them to the extent determined to be adequate and appropriate for the purposes of the audit. Such examination work also embraces the operations of obtaining information

> by means of interviews and physical inspections or contacts.[32]

The audit evidence collected, the record of audit work done, and the conclusions reached in the development of audit findings are fully documented in audit working papers which are prepared as the work is performed. The audit working papers also include background information such as the applicable laws, regulations, or contracts.

Eight steps are used in the process of developing the findings on an important weakness or deficiency.

> 1. identifying specifically what is deficient, defective, etc.
> 2. determining whether the deficiency is an isolated instance or a widespread condition.
> 3. determining the effects of the deficiency.
> 4. ascertaining the causes for the condition.
> 5. identifying lines of authority and responsibility concerned with the operations involved.
> 6. identifying and resolving applicable legal questions.
> 7. obtaining comments of persons or organizations directly involved who may be adversely affected by a report.
> 8. determining possible courses of corrective action to be recommended.[33]

All audit findings are factually supported in audit working papers and at the close of the detail audit examination a formal report is prepared from the evidence accumulated and conclusions reached. Since there

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[32] Ibid., p. 7-1.

[33] Ibid., p. 8-6 and 8-7.

is no set opinion and report format that can be used on most audits, the finished report draft goes through an extensive internal review process at both the regional and national levels.

Comprehensive audit reports are in the nature of a control using the principle of exception in which only exceptions -- deficiencies -- are audited and reported for corrective action. This audit of exceptions principle is used to attain efficient utilization of audit resources. GAO audit personnel indicated that they have no suitable "yardstick" by which to evaluate total management and that this evaluation would be uneconomical. Personal opinions on the quality of management are often formed but they cannot be supported by factual evidence either because the evidence does not exist or because it cannot be evaluated.

Criteria Used to Evaluate General Accounting Office Comprehensive Audits and Auditors

The audit standards by which the quality of audits and auditors can be judged are established by official policy statements and by operating procedures. The standards of quality and adequacy of audit work performed should not vary. Although the specific audit procedures do vary in different audit assignments, the choice of proper audit procedures is included in audit standards.[34]

Operating procedures of the General Accounting Office which control the quality of an audit come from the audit report requirements.

[34] *Ibid.*, p. 3-1.

Audit report reviews by the audit managers at the operational level and by the Comptroller General's office at the policy level are effective controls of audit quality. These reviews include consideration of policy, report tone, accuracy, adequacy, and appropriateness of audit evidence, and use of factual, objective evidence to support findings. Working papers, which accumulate audit evidence and record audit procedures used, are used to review audit reports and to provide information for the control of audit quality. Audit programs, which are prepared in detail and reviewed before the start of a detail audit examination, also provide control over the detail examination phase of an audit.

The General Accounting Office has adopted an official set of audit standards which are similar in nature to those adopted by the American Institute of Certified Public Accountants. These audit standards are presented in three groups: general or personal standards, standards of field work, and standards of reporting. These standards, unlike those of the AICPA, are stated so as to recognize the particular comprehensive audit objectives which go beyond the expression of an opinion on financial statements. They are oriented toward Government activities and organizations, and, like most Government operating policies, are quite specific. The next few paragraphs summarize these audit standards as found in the GAO's Comprehensive Audit Manual.[35]

[35] Ibid., pp. 3-1 to 3-8.

General or Personal Audit Standards of the General Accounting Office

These standards include: (1) adequate training and proficiency; (2) an independent and objective attitude; and (3) exercise of due professional care. Adequate training and proficiency standards include personal characteristics such as initiative and acceptance of responsibility; auditing skills in planning and conducting audits; and knowledge of GAO and other Government operations in budgeting, accounting principles, and various laws and regulations. Independence and objective attitude standards refer to the auditor's organizational independence from the activities audited; avoidance of participation in agency policy formulation; and the requirements for objective audit evidence which will portray a situation as it actually exists, not as the auditor would like it to be. From discussion with GAO audit personnel, it appears that any audit in which there is a question as to the validity of the findings would be considered substandard and would be improved before a report was issued. Due professional care standards include both the choice of appropriate audit procedures and the application of these procedures. As a minimum, the choice of procedures should include consideration of: (1) what is necessary to attain audit objectives; (2) the relative importance of different audit subject matter; (3) the effectiveness of management controls; and (4) the cost of audit work relative to benefits derived. All audit findings must be based upon an objective evaluation of fully supported facts obtained or developed in the audit and all reports must conform with reporting standards.

Standards of Audit Field Work of the General Accounting Office

These standards consider adequate planning and proper supervision of audit work as well as general statements of the basic operations necessary for comprehensive audits. The standards for measuring the quality of audit work performed include:

1. a study of pertinent legislative history to determine the purpose, scope, manner of conduct, extent of authority, etc. of the agency being audited.

2. a review of the policies of the agency under examination for conformity with laws and for appropriateness for carrying out authorized activities effectively, efficiently and economically.

3. a review and test of an agency's administrative system and practices for effectiveness in promoting compliance with policy, compliance with laws and regulations, operating control and efficiency, accurate accounting reports, etc.

4. the full development of any significant information necessary to support and present any findings, conclusions, and recommendations.

Standards of Audit Reporting of the General Accounting Office

Audit reports to Congress must cover all matters required by law and contain the information necessary to inform Congress on the results of the audit work in Government agencies. All subjects included in reports must be significant, accurate, and supported by facts. The reports must be objective, complete, constructive, and timely to enable Congress to act effectively on matters requiring attention. In addition to these general reporting standards, specific report format requirements and review procedures are prescribed in a Comprehensive Audit Report Manual.

The quality of an audit is no better than the quality of audit personnel employed at both the operating and supervising levels. It is not within the scope of this study to judge the quality of audit personnel, although some measure may be obtained from the fact that about twenty percent of the accounting, auditing, and investigating staff of the General Accounting Office are CPA's,[36] and that GAO experience will partly or fully satisfy CPA experience requirements in several states.[37] The approach in this section has been to describe some of the criteria used to evaluate comprehensive audits and auditors. Discussions with GAO audit personnel and a review of audit policies, programs, and working papers indicate that the review requirements and the emphasis on factual support for all conclusions reached do result in quality audit reports. However, there is no way to evaluate the audit decisions about the scope of audit subject matter and audit reports except by the fact that there is final responsibility to Congress and the audit work must satisfy Congress.

Criteria Used to Interpret Comprehensive Audit Evidence

In Chapter IV, five general categories of standards were described as applicable to the evaluation and interpretation of management audit evidence. The objective of this section is to describe the

[36] Comptroller General of the United States, *op. cit.*, p. 8.

[37] Ellsworth H. Morse, Jr., "The Case for Accepting GAO Experience," *The Journal of Accountancy*, V. 109, No. 6 (June, 1960), p. 61.

criteria actually used in GAO comprehensive audits in terms of these general categories, and to illustrate the interpretive criteria that are currently used in this type of management auditing. The approach used is to consider both those criteria suggested in the GAO's Comprehensive Audit Manual and those criteria used to support the opinions and conclusions appearing in audit reports. Reports on special investigations for congressmen are confidential and, therefore, not included as a source of criteria used in audit reports.

GAO audit personnel indicated that they use four basic types of criteria to interpret comprehensive audit evidence and draw conclusions thereon. These four types of criteria are:

1. laws and regulations applicable to the particular activity being audited.

2. Agency's or contractor's self-imposed criteria through stated objectives, policies, procedures, etc.

3. Common knowledge of what constitutes acceptable principles of good management.

4. GAO created criteria supported by actual examples.

The quantity of audit evidence needed to reach an opinion varies with each of these four types of criteria. The least evidence is needed for those criteria based upon laws and regulations and the most evidence is needed for those criteria developed by the GAO. One of the functions of the numerous internal reviews of audit reports is to determine whether the audit evidence collected is of sufficient quantity and quality to support the conclusions reached considering the type of interpretive criteria used. Some auditors tend to overreach their evidence and the internal audit report reviews lessen the possibility of this happening in the final audit report. Comprehensive audit criteria are classified and described in the balance of this section by using five general categories of social standards, economic standards, legal standards, standards of controlling interests, and standards of management skill.

Social Criteria Used in Comprehensive Audits

There is little distinction between the social criteria, legal criteria, and criteria of controlling interests used in comprehensive audits. Congress is an agency of the public which makes laws and which controls the General Accounting Office; therefore, Congress is the public representative which enforces social standards, establishes the law used as legal criteria, and controls the operations of Government agencies. As used here, social criteria include only the interpretive criteria used in comprehensive audits which have not been formally recognized by Congress. Social criteria include the criteria for determining, "whether the agency's practices result in promoting or protecting the interests of the government, all factors considered."[38] Most social criteria used are GAO created criteria and are well illustrated in audit reports by case examples. When the GAO expresses comprehensive audit opinions in areas of public policy where it is not considered an expert, the basis of the

[38]United States General Accounting Office, "Comprehensive Audit Manual, Volume I" (Unpublished), p. 6-3.

opinion must be clearly presented. Third parties will not accept conclusions and recommendations merely because they are stated.[39]

In actual reporting, public policy opinions are infrequent and are based upon well illustrated examples. Some of the criteria used are: (1) unnecessary expansion of Government activities in taking over activities adequately performed by private interests, (2) impairment of tactical military readiness; (3) danger to personnel from poor safety conditions in storage areas; and (4) inadequate public protection in the commodities futures market. Social criteria are often developed from comparisons with other activities in either Government or private operations. Social criteria for interpreting the evidence found in the commodities futures market was developed from knowledge of the Securities and Exchange Commission's experience with the stock market.

Economic Criteria Used in Comprehensive Audits

In its broadest sense, economics refers to the allocation of scarce resources to satisfy unlimited wants and, in this broad sense, economic criteria would include all factors used to form opinions about Government related activities. However, the term economic criteria is used here in a more restricted sense to refer to the evaluation of the economical use of resources as measured by the outlay of public funds. Laws and regulations usually require the economical use of public

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[39] Ibid., p. 8-5.

funds and are the most common economic criteria used by the GAO to interpret audit evidence and form an opinion thereon. Some of the factors considered in audit reports are: (1) maintenance of land uneconomically in excess of needs and contrary to laws and regulations; (2) failure to negotiate the best price on a contract as required by law; (3) excessive costs to the Government on contracts based upon the requirement for fair and reasonable prices in public law #87-653, and (4) excessive building costs in public housing contrary to legislative regulations. Self-imposed economic criteria of agencies and contractors are used to interpret audit evidence in instances such as the loss of receipts due to the Veteran Administration's failure to follow its own policies in collecting defaulted housing loans and uneconomical procurements by the government due to various agencies' failures to implement contract review policies on negotiated contracts. In these findings the conclusions are drawn from the policies and procedures established by the agencies under audit.

General management principles and GAO created economic criteria consider factors such as duplication of effort, ineffective or wasteful utilization of resources, and work backlogs.[40] Examples of this type of economic criterion used in audit reports are: (1) general principles of accuracy applied to errors in computing contract costs; (2) general commercial storage rates compared to those paid by the Government; (3) general principles of least cost used in comparing

[40] *Ibid.*, p. 6-3.

prices paid to a contractor for an item with prices paid by other customers of the contractor; and (4) general principles of reusing shipping containers when it is economical as determined by comparisons with practices of similar commercial activities.

Legal Criteria and Control Requirements Used in Comprehensive Audits

The two categories of legal and control criteria are combined because the controlling interest in the audit client of the General Accounting Office is the Government which also makes the laws and establishes the regulations which form the legal criteria used to interpret audit evidence and form opinions thereon. Legal criteria are applicable in audits of all areas of Government operations and they form a part of the categories of economic standards and standards of managerial skill. Some of the specific legal criteria to be used are identified in the Comprehensive Audit Manual. These are: the statutory requirements for accounting systems and internal control established by the Budget and Accounting Procedures Act of 1950, the bulletins of the Bureau of the Budget, the report requirements of the Treasury Department, and the regulations of the General Services Administration and the Civil Service Commission.[41] Other examples of legal criteria used to interpret audit evidence for audit reports are: (1) Public law #87-653 used as a basis for opinions on the procurement policies of Government

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[41] *Ibid.*, pp. 11-6 and 11-7.

agencies; (2) Federal laws governing parking policies used to evaluate GSA parking policies and activities; (3) Laws authorizing FHA loans used to form an opinion on FHA refinancing activities; and (4) Laws controlling grants-in-aid used to form opinions on the allocation of school facility costs in urban renewal programs.

Criteria of Reasonable Management Skill Used in Comprehensive Audits

The General Accounting Office forms opinions on managements' skill in the application of appropriate laws, regulations, and policies as well as on managements' decisions not specifically considered in regulations. When using this type of criteria to form an audit opinion the auditor must assume the burden of proof and the proof must come from evidence of management's prior knowledge at the time the decision was made. The comprehensive audit manual states that "We should not be critical of a decision unless we can show that it was clearly inappropriate on the basis of information available at the time the decision was made."[42] Another section of the audit manual provides the following limitation on criticism of management's abuse of its discretionary powers:

> On the other hand, in exercising their discretionary powers, agency officials may make decisions with which we disagree. We should not be critical of these decisions if they appear to have been based on adequate consideration of the facts available at the time, and also were reasonable in the light of these facts. Nor should we be critical just because we hold a different opinion as to the nature of the decision that should have been made. We must not substitute our judgment in such

[42] Ibid., p. 8-5.

> matters for that of agency officials. Our criticisms under these circumstances should be based on the results or effect of the decision on the agency's program, operations, expenditures, etc.[43]

GAO audit personnel indicate that in the course of a comprehensive audit they usually form an opinion on the relative ability of management. However, in most cases these are personal opinions and, unless management deficiencies are materially unfavorable to the Government and can be very well documented, they are not reported. Managerial skill is evaluated in all audit reports which reach conclusions about deficiencies in operations and, in effect, the audit report presents audit findings and makes recommendations for improvement but lets the report reader form his own opinions about management. Some of the criteria used in those audit reports which express opinions on management's skill in performing a particular activity are: (1) approval of a budget known by management to be unreasonable; (2) procurement guidelines not specific enough to be usable, (3) no supervisory reviews of V.A. loan refinancing; (4) failure to obtain enough information to accomplish objectives in the case of controlling the commodities futures market; (5) lack of review policies or procedures to insure that instructions are followed, (6) rejection of an employee suggestion which would have saved costs; (7) failure by V.A. officials to initiate policies and procedures to follow up loan defaults; (8) lack of information about possible uses of excess supplies, (9) failure to attain program objectives as measured by actual

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[43] Ibid., p. 8-6.

operating results accomplished; and (10) inconsistent practices resulting in the granting of disapproved loans.

As in all comprehensive audit reports, the criteria used to form opinions on management skills are applied only to evidence of management deficiencies. However, many reports also consider the corrective actions taken by management and may be qualified as being only informational because the deficiency has been corrected.

Summary of Comprehensive Audits by the General Accounting Office

Comprehensive audits as applied to executive agencies of the Federal Government and to private organizations receiving Federal funds are one of the most inclusive forms of management auditing. Auditing by the General Accounting Office is comprehensive in that almost any activity using Federal funds may be selected for audit and almost any part of these activities -- policy, performance, etc. -- may be audited. However, in practice individual comprehensive audits are restricted rather than comprehensive. A narrow subject is selected from the wide range of applicable subject matter for application of detailed audit examinations. These audits are comprehensive only in the sense that any topic is eligible for a detailed examination. The characteristics of this auditing as summarized below further emphasize this rather restrictive meaning of "comprehensive" when applied to audits by the General Accounting Office.

Characteristics of Comprehensive Auditing

The General Accounting Office has a greater degree of independence than most internal auditors since it is not directly responsible to the executive branch audited. The primary responsibility is both to individual congressmen and to Congress acting as a body. Responsibility to other audit users -- public, executive agencies, and Government contractors -- is indirect because any controlling action must be effected through Congress. In actual practice this secondary responsibility does influence audit investigations because Congress tends to be sensitive to public opinion and the GAO tends to be sensitive to congressional interests.

The subject matter of comprehensive audits may be any part of any activity involving the application of Federal funds. The audit may be directed toward policies, procedures, or activities, and may emphasize the effectiveness of a total program or one small part. The subject of a detail audit examination is seldom as broad as the management of an agency, rather it is usually one specific policy, procedure, or activity which is in some way considered to be deficient. Comprehensive audits are distinguished by the emphasis upon selecting a specific audit subject from an originally very broad area. Efficient use of audit staff in an economic sense usually limits the audit report to deficiencies found rather than general evaluations. In the detailed examination, any type of evidence may be used to support findings. The more subjective the criteria used for the opinion, the more evidence is needed.

Audits and auditors of the General Accounting Office are evaluated by Congress in the final analysis. Internally the GAO uses standards similar to those of the AICPA and relies upon a very extensive review of all audit reports. The criteria used to evaluate audit evidence in order to reach an audit opinion are also frequently the requirements or intent of Congress. These criteria are directly those of the controlling interest and of laws and indirectly those of economic efficiency, public interests, and reasonable management skill. These criteria will be further summarized and conclusions drawn in Chapter IX.

Requirements for Successful Comprehensive Audits

The following list summarizes those factors that appear to be necessary for the successful application of comprehensive auditing by the General Accounting Office.

1. audits are mandatory since the Federal agency and contractor must submit to audit and has no choice about the scope of the audit; management must cooperate and be kept informed.

2. a preliminary survey is required for working knowledge but the detailed audit must be narrowed to an auditable specific problem for which a specific set of objectives and program can be developed.

3. a flexible audit report format is needed to permit reporting of a wide range of findings.

4. The auditor must have entree into any area and, to be economically justified, the emphasis is upon deficiencies.

5. the auditor must have organizational independence and must use an objective approach in which only the opinions supported by factual evidence are reported.

6. audit evidence must be fully documented in working papers for review purposes and subsequent support of conclusions.

Limitations of Successful Comprehensive Audits

The following list includes those factors appearing to limit the general success and ultimate applications of comprehensive audits by the General Accounting Office.

1. audits are limited to subjects of congressional interest which normally require adverse findings and recommendations for improvement but leave the unpopular stigma of "bumbling management."

2. audits usually do not evaluate general programs or result in opinions on service to the general public because of a lack of satisfactory criteria for interpreting audit evidence.

3. audits take so much time and audit effort that they are not economically feasible in a broader scope in which some assurance of improvement is not available.

4. large amounts of audit evidence are needed when evaluations are based upon subjective criteria.

5. audits are often halted if the potential for adverse findings is not great enough thus eliminating the possibility for favorable opinions.

CHAPTER VII

AUDITS AND MANAGEMENT SERVICES BY CERTIFIED PUBLIC ACCOUNTANTS

The material in the previous two chapters of this study has dealt with management audits as conducted by various types of internal auditors, including both the United States General Accounting Office and the United States Army Audit Agency. This chapter and the following chapter consider management type audits conducted by various external auditors. The term "external audit," is chosen to distinguish these audits from internal audits instead of the term "independent audit" because of the wide range in the extent of independence that can exist from one audit group to another.

This chapter describes and analyzes the activities of Certified Public Accountants and public accounting firms in terms of the relationship of these activities to the concept of management auditing developed in this study. The objectives are to determine whether these activities are consistent with the broad concept of auditing used in this study, whether management audits can be applied by external auditors as well as internal auditors; and, if the activities are consistent, the requirements and limitations of successful application. This analysis is also imperative for any conclusion as to which audit group, if any, is best qualified to conduct management audits.

The emphasis in this chapter is upon description and analysis of audits and management services by public accountants. It considers the development and current status, nature of client and responsibility, nature of service, and nature of criteria used to interpret evidence in management service engagements. A subsequent chapter considers the activities of other external audit groups.

Audit Activities by Certified Public Accountants

Usually the audit by a Certified Public Accountant is considered to be only that set of activities which leads to the issuance of a published opinion on a limited number of an organization's financial statements. The typical description of this auditing is:

> . . . the objective examination of financial statements accompanied by the expression of a competent opinion concerning the fairness of the presentation of those financial statements. [1]

However, under the broader definition of auditing used in this study, many other activities of the Certified Public Accountant may be classified as auditing. In addition to audits of financial statements, the two types of audit activities that are applicable for this study are those leading to an expressed opinion on management performance and those generally described as additional services to management in which no opinion is expressed.

Financial Audits and Other Audit Services by Certified Public Accountants

In a general sense, financial statement audits can be considered

[1] Arthur W. Holmes, Auditing Principles and Procedures (sixth edition; Homewood, Illinois: Richard D. Irwin, Inc., 1964), p. 3.

one form of management audit because financial statements are indicators of the relative success of managements' operation of the organization. These audits consider only one aspect of management performance; that of accurate periodic reporting of the results of operations and the current financial position. Other management audit type activities are used in the financial audit, such as the review of internal control in which managements' performance in developing and carrying out satisfactory policies to control the accuracy of financial data and financial reports is evaluated. However, this review is used as an audit procedure in the financial audit only to evaluate the ultimate fair presentation of financial statements.

Some practicing independent auditors have advocated and are applying an audit utilizing the business approach which emphasizes an evaluation of an entire business enterprise rather than just that of financial data.[2] In this approach the objective is a better technique for the audit of financial statements rather than an audit of other aspects of an enterprise. The approach seems to be one of evaluating operations and performance for a comparison with the impression given by the financial statements. In addition this approach permits additional "non-audit" services to the client. These "non-audit" services will be considered further in conjunction with management services by Certified Public Accountants.

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[2] Carl Tietjen, "Changes in Public Accounting," The Journal of Accountancy, V. 105, No. 5 (May, 1958), p. 37.

In one large firm of Certified Public Accountants, management services other than the financial audit activities are divided into two separate activities· operational audits and management services. The operational audit, for which a standard audit program is developed, is conducted by the auditing staff. In this operational audit, a preliminary survey is made of some aspect of the client, such as production, and any problem area detected is followed up with a more detailed study leading to an evaluative report to management. This report includes the audit findings, the auditors' evaluation, and the recommendations for improvement, if any. Any extensive study, revision, or implementation of a new system is done by the management services staff rather than the audit staff.*

One partner in this firm concluded "the applications of this operational audit have been very satisfactory." Much of the analysis of internal auditing is also applicable to these operational audits. In many cases, the independent auditor is merely acting as an expert substitute for internal auditors. This operational audit approach and other "non-audit" services are included with general management services later in this chapter and their relationship to management auditing is considered further in the conclusions of this study.

It has been suggested that audits and opinions by Certified Public Accountants can be made more useful by attesting to more information in

*From discussions with a partner in the Des Moines, Iowa office of Lybrand, Ross Bros. & Montgomery.

annual reports,[3] but at the present time this is not done nor is it permitted by the American Institute of Certified Public Accountants. Several authors have recently called attention to the fact that in the Scandanavian countries the independent auditor renders an opinion on management's fulfillment of its responsibilities and whether management should be discharged from future liability.

Management Audits by Scandinavian External Auditors

Analysis of the management audits conducted in Sweden and Finland reveals that the audit opinion satisfies certain legal requirements and that the actual audit examination is little different from examinations conducted by independent auditors in the United States.[4] Bomeli writes that "the Swedish and Finnish audits accomplish approximately what a combination of management services and the traditional financial audit together would be in this country.[5] It would be difficult to judge the increased information, if any, received by those parties who use annual reports in Sweden and Finland. On this point Bomeli quotes J. E. Harris as stating that his studies of Swedish and Finnish audits show that the auditor gives advice about managements' efficiency to the management, and not directly to stockholders. Management is free to accept or reject this advice.[6]

[3]Herman W. Bevis, "The CPA's Attest Function in Modern Society," The Journal of Accountancy, V. 113, No. 2, (February, 1962), pp. 34-35.

[4]Edwin C. Bomeli, "Management Reviews by Scandinavian Accountants," The Journal of Accountancy, V. 118, No. 1 (July, 1964), pp. 36-37.

[5]Ibid. [6]Ibid., p. 36.

Scandinavian audits cannot be considered complete management audits as the concept is developed in this study; however, they are indicative of an attempt to conduct such audits, at least in the area of managements' compliance with certain legal requirements. These audits and the resulting opinions do indicate that in a very mild form management audits leading to an opinion thereon are acceptable to external auditors, management, and outside interests. In both the United States and the Scandinavian countries any evaluation of management efficiency is in the category of other services by auditors and is communicated to management only.

External audit activities of Certified Public Accountants in the United States do not lead to a direct opinion on managements' plans, policies, procedures, and activities. Informal reports and recommendations on non-financial activities are made to management but these are not recognized as audit reports in the same sense as the opinion on financial statements, nor does the external auditor assume the same responsibility to third parties for these informal reports. Certified Public Accountants detailed examinations of managements' plans, policies, procedures, and activities, which do not affect financial statement presentations, are classified as management services and will be analyzed further in the balance of this chapter. Other audit services of a management service type are also considered as they and management services relate to the concept of management auditing used in this study.

Management Services by Certified Public Accountants

Historical Background of Management Services by Certified Public Accountants

There is no one definition of management services which has universal acceptance. Definitions range from services to management in the area of financial systems to all services other than the ordinary financial audit. The definition used in this analysis is the one included in the Management Services Handbook.

> A review of management controls by CPA's can be defined simply as an extension of the CPA's regular work for the purpose of examining and assessing the adequacy of management's policies, directives, and procedures, which together constitute the system of management controls, to determine that they produce optimum efficiency -- the logical result of which is maximization of profit.[7]

The development of the Certified Public Accountant's interest in management services is often attributed to changes taking place in the post World War II period; however, the use of auditors' knowledge about business to review functions other than accounting was present in external audits for many years before World War II. Grady writes that independent auditors have rendered services to clients in taxes, systems, and industrial engineering for over forty years.[8] Early independent public accountants emphasized reviews of the accounting

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[7] Henry DeVos (ed.), Management Services Handbook (New York: American Institute of Certified Public Accountants, Inc., 1964), p. 2.

[8] Paul Grady, "The Independent Auditing and Reporting Function of the CPA," The Journal of Accountancy, V. 120, No. 5 (November, 1965), p. 67.

informations system;[9] and as more advanced management information and decision making techniques have been developed, the public accountant has reviewed the use of these techniques and has made recommendations to assist management in their application.

Throughout the history of public accounting the performance of both audits and management services has been an accepted part of the Certified Public Accountant's practice because of the common knowledge needed for both. The separation of the two types of services into distinct parts of public accounting practice is of more recent origin.[10] The separation of the audit and management services functions since World War II has led many observers to the conclusion that management services are new rather than a continuation of an established practice. The accelerated growth of management services, which began in the post-war period with the advent of computers and advanced management techniques, has been initiated by businesses seeking outside help. Accountants have responded to these demands and only recently have begun to take the initiative in offering management services.[11] The Certified Public Accountant's role in additional services to management is more active

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[9] A. C. Littleton and V. K. Zimmerman, Accounting Theory: Continuity and Change (Englewood Cliffs, New Jersey: Prentice Hall, Inc., 1962), p. 109.

[10] Robert M. Trueblood, "The Management Service Function in Public Accounting," The Journal of Accountancy, V. 112, No. 1 (July, 1961), p. 37.

[11] H. G. Trentin, "The CPA in Management Services: A survey and Projection," Management Services, V. 2, No. 2 (March-April, 1966), p. 19.

than in the past. Some authors have stated that up to forty percent of the revenue of some large accounting firms comes from management services.

The Current Nature of Management Services by Certified Public Accountants

Current management service activities are varied, and due to their confidential nature, descriptions of specific engagements are not available in published literature. The following analysis of management services comes from published general descriptions rather than descriptions of specific engagements and is developed by consideration of the responsibility, subject matter, service, and criteria found in this material.

Responsibilities of Certified Public Accountants in Management Services

As in management audits by internal auditors the independent public accountant is responsible to management for the results of a management services engagement. The subject matter and service are necessarily those acceptable to management and the results are evaluated by management. Engagements are usually initiated at the request of top management of an organization and the resulting opinion and recommendations are directed toward this level. There is no responsibility to external parties; however, Certified Public Accountants who are members of the American Institute of Certified Public Accountants are responsible for exercise of due professional care in any activity performed.

Subject matter of management services. The nature of the subject matter can vary extensively although most management service engagements involve the financial departments and information systems of a business. A part of the Certified Public Accountant's financial audit examination is a review of controls in financial and related areas to determine the extent of audit testing that will be necessary. This evaluation often leads to the recognition of problem areas in which management services are needed. However, problems in operating departments, management organization, personnel, etc. may also be recognized in the course of a financial audit and lead to a management services engagement. In other instances a business may recognize its own problem areas and request the management services.

The Management Services Handbook lists eight areas of business subject to management services and important enough to warrant chapter coverage. These areas are:

1. Management controls
2. Financial planning
3. Inventory or production controls
4. Systems and procedures
5. Systems mechanization
6. Cost reduction
7. Office management
8. Operations research[12]

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[12] DeVos, op. cit., pp. v-vi.

The scope of possible services within these eight areas seems to be unlimited. A sample checklist in the area of management controls covers factors such as: company objectives, company policies and principles of operation, organization, market research, advertising and sales promotion, distribution, equipment and facilities, research and engineering, public relations, and many others.[13] While many Certified Public Accountants limit the fields of management services activities to those related to systems, procedures, and controls, others practice in broader fields similar in many respects to those of management engineers or consultants.[14]

Services performed in management services engagements. Regardless of the business client or the particular subject matter within a business, the basic approach of management services is similar to that of management auditing. In both, a tentative problem area is established, evidence is collected and analyzed, and an opinion and report are formulated based upon this evidence. This report goes to the top management of the organization served and, if necessary, makes recommendations for correcting deficiencies. Any actions taken as a result of this report are at the discretion of management. All management services work must be done in close cooperation with management and there are usually

[13] *Ibid.*, pp. 19-30.

[14] Trentin, *op. cit.*, p. 18.

no surprises to management in the report.[15]

Several practitioners have described the basic approach in management services; one such author lists the following five basic steps of an engagement:

1. Gather facts
2. Analyze facts
3. Consider the alternatives
4. Develop recommendations
5. Implement the changes[16]

In explaining the five steps of an engagement, the author writes that all too often an engagement begins with step five, "install a computer," when it should begin with a definition of the problem. Another author points out that the most important part of management services is the definition of the problem. He writes that "once we have reached an agreement with the client on the scope of the problem, we are, we feel, perhaps fifty percent along the way."[17]

To compare management services by external accountants to management auditing, it is necessary to identify two separate phases of a management services engagement. These two phases represent different approaches and philosophies and may or may not be separated in time and application of effort. The first phase includes steps one

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[15] George S. Olive, Jr., "Reporting to Clients," Management Services, V. 2, No. 4 (July-August, 1965), p. 49.

[16] Harley H. Rudolph, Jr., "Flow Charting -- A systems and Control Technique," Management Services, V. 3, No. 5 (September-October, 1966), p. 26.

[17] Olive, op. cit., p. 47.

through four above which are the definition of the problem, gathering and analyzing the facts in a particular situation, and formalizing these facts and alternative courses of action, if any, into a formal report to some level of management. The formal report may include either explicit or implicit recommendations for future courses of action on the problem. Phase two is the assistance in implementation of recommendations or the selection of the best alternatives and carrying out the necessary changes. This phase also includes subsequent follow-up to test the workability of changes made.

There is little difference between the first phase of management services and management auditing as defined in Chapter III of this study.[18] Also, the similarity of management services and operational audits by both Certified Public Accountants and internal auditors is illustrated by the fact that the benefits of management services are potentially greatest in small businesses which do not have an active, progressive internal audit staff.[19] Management service activities go beyond those of management auditing when a client is assisted in choosing alternatives and implementing recommendations made in the report. The effects of this second phase of management services on the correlation of management services to other forms of management

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[18]A management audit is an analytical examination of a management's financial and economic plans, policies, and activities. The examination leads to a report evaluating these plans, policies, and activities and recommending improvements where possible.

[19]DeVos, _op. cit._, p. 2.

auditing will be considered further in a later section of this chapter.

Criteria Used to Evaluate Management Service Activities and Evidence Collected in an Engagement

Certified Public Accountants, if members of the American Institute of Certified Public Accountants, who perform management services or operational audits are subject to the By-Laws and Code of Professional Ethics of the Institute and the requirements of the state in which they practice. A member of the AICPA may not undertake a specialized management service beyond the scope of his professional competence, nor should any employee undertake an activity in which the Certified Public Accountant is not competent to review the work.[20] The generally accepted standards of proper planning and supervision and exercise of due professional care apply to management services as well as to financial audits; however, there is currently an unresolved question of the applicability of other standards, such as independence, to management services practices.

In general the criteria used to interpret and evaluate evidence obtained in a management services engagement include any available source of information. Often the approach is that if a better, more economical system, procedure, policy, or plan can be devised, an opinion can be rendered to management with recommendations for improvement. No references were found to engagements in which no

[20] American Institute of Certified Public Accountants, BY-Laws, Code of Professional Ethics (New York: American Institute of Certified Public Accountants, 1965), pp. 35-52.

deficiencies were found and no recommendations for improvement were made. Most management services engagements are not begun unless symptoms of inefficiency or lack of control become apparent or unless problems are anticipated.[21]

There are two levels of evidence collection and interpretation in a management services engagement. The first level is that which takes place in reaching a decision as to whether a problem exists and whether further management services are needed. Authors on the topic point out that the starting point of an engagement is often the financial audit. In these instances some of the evidence needed for management services has been collected and tentatively analyzed before the actual engagement is begun. This first level of evidence collection and interpretation is similar in nature to the preliminary survey of operational audits. The second level of evidence collection is that which follows up on a specific deficiency and leads to a report thereon. This second level corresponds to the detail examination in operational audits. One public accounting firm attempts to separate the activities of the financial audit and the preliminary survey for management services. In this firm an operational audit is conducted by the audit staff as a form of preliminary survey. In other instances the first level -- preliminary survey -- may be conducted by management itself in deciding whether to seek outside assistance.

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[21] Rudolph, _op. cit._, pp. 26-27.

The five general categories of criteria used to evaluate evidence about management, as set out in Chapter III,[22] are applicable to both levels of management services. All of these five categories are within the broad topic of principles of good management. The current literature on management services includes examples of recommendations made to clients, and the criteria used to evaluate evidence collected is either expressly stated or implied. No detail description of these findings is included here; however, two examples are used to illustrate that such criteria do exist and are being used to evaluate evidence, form opinions, and prepare reports thereon.

Standards pertaining to a client's economic environment are often used in management services engagements. One practitioner relates his experiences with an executive compensation study in which the opinion and recommendations of the final report were based upon the relationship of the client's current policies to assumptions of the economic climate in the next three years, the long-term debt to be added by the client, future net income of the client, and the client's policies for future issuance of preferred and common stock.[23] The author does not mention consideration of legal standards nor the requirements of controlling ownership interests, however, these would also need to be considered in an executive compensation plan.

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[22] Social standards, legal standards, economic standards, requirements of controlling interests, and requirements of skillful management.

[23] Olive, op. cit., pp. 48-49.

Standards of skillful management performance and standards derived from the economic environment were applied in experiences cited by another management services practitioner This author cites several cases in which management performance was improved when his recommendation to use outside data processing services was adopted. The author's recommendations were the result of a management service engagement finding of inefficient data collection, summary, and analysis.[24]

Summary of Management Services by Certified Public Accountants

There are two phases in management services engagements; the first phase is the collection and evaluation of evidence resulting in the issuance of a formal or informal report to management of the client, the second phase, when performed, is direct assistance in implementing recommendations included in the report. The following summary of characteristics applies to only the first phase; the second phase is considered separately in the following section.

Characteristics of management services. Management services are similar in nature to management audits by internal auditors and government auditors. The external accountant does not assume direct responsibility to outside third parties for the results of his review

[24] David Coleman and Theodore Cohn, "Some Specialized Uses of Data Processing Centers," Management Services, V. 2, No. 5 (September-October, 1965), pp. 43-46.

nor are the reports normally made public. The concept of auditing and management auditing developed in this study does not necessarily require third party reliance on audit results. In contrast to internal auditing, the results of management services are usually reported to top management and responsibility for audit results is at this level. Another difference in responsibility and independence is that management services are conducted on a fee basis rather than by employees as in internal auditing. Management services can be tentatively described as a high level of operational auditing conducted with an external point of view.

Since management decides when management services are needed, the subject matter of an engagement will be that selected by management. The subject matter varies extensively and no aspect of an organization's plans, policies, procedures, activities, and personnel is excluded. Most current engagements emphasize systems, procedures, and controls due to the qualifications of the public accountant. Certified Public Accountants who are members of the American Institute of Certified Public Accountants are subject to restrictions limiting their activities to ones in which they are qualified and in which they can exercise due professional care.

The procedures followed in management services are also similar in nature to those of other forms of management auditing described in this study. The examination begins with a preliminary survey and eventually emphasizes some specific problem area in which weaknesses are known or suspected. The preliminary survey and problem identification can be conducted by the public accountant or by management before engaging the accountant. There is little evidence of management service applied to an organization as a whole due to both a lack of management's acceptance and a lack of qualifications by the CPA for this type of review. Management services are more frequent and more successful in structured situations such as are involved in adaptation to a computerized system.

Certified Public Accountant's activities in management services are judged by the standards established for the profession and, although there have been no notable cases of unethical practice in management services, a certain minimum level of qualification does exist. Few generally accepted standards are available to evaluate evidence collected in a management services engagement. In practice these standards appear to be developed and defined when needed in a particular engagement. The standards used can be from the general environment such as economic conditions, legal requirements, and general social standards of public interest. Standards can also be developed with an internal point of view such as the requirement for reasonable managerial skill in carrying out assigned duties.

<u>The implementation phase of management services</u>. The review and report phase of management services has been shown to be similar in nature to management auditing. The implementation phase, which encompasses active assistance, advice and follow-up, is very similar to the actual practice of management. It is true that management

must take final responisbility for any decisions made or action taken and the Certified Public Accountant usually only acts as an advisor; however, this same relationship exists with any staff employee of a business whose position depends upon the quality of his advice and assistance.

In an earlier chapter of this study it was pointed out that one of the requirements of an audit is that it be conducted by a person other than the one responsible for the original action. This requirement applies to both the financial audit and the management audit. The implementation phase of management services cannot be considered as an acceptable audit activity and would weaken the independence of the public accountant.

There is a question of the applicability of the generally accepted auditing standard of independence when both financial audits and management services are conducted for the same client. It is well established that a part of the independent financial audit is the review of procedures and control systems in financial and related areas to determine the extent of audit tests required. It is generally accepted that the auditor should forward this evaluation to management with recommendations for improvement when applicable as an additional service of the audit. This same approach applies to information and recommendations in other operating areas such as inventory, cost reporting, production, purchasing, etc. It is possible for this management review activity to be a part of the normal financial audit, or, if extensive, to be a separate management service or operational audit engagement without impairing the independence for financial auditing.

Management services may be extended to include assistance to the client in improving its system and installing recommended improvements just as an independent auditor may assist a client by performing certain accounting duties and acting as chief accountant, controller, or director for the client. However, in both cases above, the auditor could not be considered independent if he subsequently performs a financial audit or management review. The nature of an audit report or opinion includes direct or implied recommendations to the client and the review and reporting of recommendations in management services is not inconsistent with the issuance of an opinion on financial statements. However, when the public accountant's services include direct assistance to the client in either accounting or management activities, he is no longer regarded as capable of conducting an independent audit of this client.

When management service engagements go beyond the scope of auditing and enter the field of management practice it is unclear whether this inconsistency is due to a poorly defined concept of auditing or whether it is due to the peculiarities of management services by public accountants. It also appears that when public accountant's actively assist management in a management service engagement there would be more impairment of independence in a subsequent management review than in a subsequent financial audit. The interrelationship of management services and financial auditing will be considered further in the concluding chapter of this study.

Requirements and limitations of successful management services.

The requirements and limitations for successful management services apparent from the preceding research and analysis of the topic are summarized below.

Requirements:

1. management must request the services, cooperate in their application, and expect to receive some measurable benefits.

2. a specific problem area in which weaknesses are known or suspected must be identified either before the engagement or in the early phases of the review.

3. for best results the management services should be applied to a structured operation in which objectives and responsibilities can be well defined.

4. the final report form must be flexible, may be either formal or informal, and include recommendations for improvement.

5. the external accountant must be qualified and exercise independence in his conclusions.

6. some criteria must be used to evaluate evidence even if it is developed and defined by the performer of the management services.

Limitations:

1. management services reports and recommendations are often combined with implementation of the recommended changes which is more the practice of management than the audit of management.

2. the subject for review is selected by management rather than the auditor and the ultimate usefulness to anyone other than management is limited.

3. management services as currently performed are not well suited for general evaluations of total management due to both the auditors lack of qualifications and managements' lack of desire.

4. criteria for evaluating evidence collected are poorly defined and practices are not uniform in each engagement or by each auditor.

5. auditor qualifications are limited in areas other than financial systems and controls.

6. reports are not made public thus limiting the ultimate usefulness of management evaluations.

Management services are a logical extension of financial audit by external auditors because they provide a way of using some of the knowledge obtained in a financial audit which does not apply directly to financial statement presentations. The findings of this chapter will be further summarized and conclusions drawn in Chapter IX.

CHAPTER VIII

MANAGEMENT AUDITS BY EXTERNAL AUDIT GROUPS

This chapter is a continuation of the previous chapter on activities of external auditors. The term external audit is chosen to represent those groups who review managements' activities from a vantage point outside the enterprise audited and who are not employees of the enterprise audited. The list of these external groups is not meant to be all inclusive. It includes only some major groups selected as examples of the efforts applied in this area. The groups chosen for analysis are the American Institute of Management, management consultants, and state and federal bank examiners. In addition to these groups, brief consideration is given to other approaches to management auditing such as that applied in management games and to non-audit groups such as bankers, financial analysts, and other stockholder representatives.

The objective of these brief analyses is to consider some other aspects and approaches currently used to appraise management. These activities provide useful information for the concept of management auditing as it currently exists and also provide further information on the limitations and requirements of successful evaluation of management performance. The additional information, whether consistent with the concept of management auditing or not, provides a better basis for a conclusion as to what group, if any, is best qualified to conduct such audits. The basic approach to these descriptive analyses is similar to that used in previous chapters in which the development and current status, nature of responsibility, subject, and service, and nature of standards are considered.

Management Consultants

Of the external audit groups considered in this study, the management consultants are the most varied. Consulting activities are similar in nature to the management services performed by Certified Public Accountants, but management consulting goes beyond most management services. Consulting is briefly considered here to obtain a broader coverage of this extensive audit-like activity and its relationship to management auditing.

Historical Background and Current Status of Consulting

Historically, management consulting probably began as far back as management itself. As a study by Karl Morrison points out, all managers have friends and relatives who offer solutions to management problems with great assurance and little objectivity.[1] The development of a recognized group of specialists in advice to management began its more rapid growth and recognition at about the beginning of the twentieth century with leaders such as Taylor, Emerson, and others.

In the broadest sense, management consulting is an exchange of

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[1] Karl Morrison, Management Consulting of Small Business in the United States (Prepared by The University of Mississippi under a Small Business Administration Grant to the Mississippi Industrial and Technological Research Commission, 1963), p. 180.

opinion on future procedures with the purpose of making the best decision in a specific situation. It concerns advice about how a management function should be performed. It may also include the performance of management functions that may be necessary from the advice given.[2] Management consulting is conducted by many, varied groups and individuals such as a business's customers, suppliers, bankers, stockholders; by the government or government sponsored agencies; and many others. The group of practitioners of interest in this study are the professional management consultants.

A 1963 study of professional management consultants found that the number of consulting firms, using an acceptable professional definition, was 1250 at that time. Most of these firms had five or fewer professional staff members, but several were large nationally known firms.[3] The 1963 study also found that many large business enterprises had used the services of management consultants, but that less than one percent of the United States businesses used consultants in any one year.[4] In recent years particular emphasis has been placed upon the value of management consulting for small businesses. The above 1963 study and other work by the Small Business Administration offices of the

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[2] William E. Green, R. Selby Downer, and Joseph Cerny, Case Studies in Management Counseling of Small Manufactures (Prepared by The University of Mississippi under a Small Business Administration Grant to the Mississippi Industrial and Technological Research Commission, 1963), p. 157.

[3] Morrison, *op. cit.*, p. 52.

[4] *Ibid.*

Federal Government have emphasized this approach.[5] Independent public accountants performing management services are not included in the group of professional management consultants surveyed above, but many authors include them when considering the various activities of consultants. For this study management services and management consulting are analyzed separately although much of the following applies to both.

The field of professional management consulting includes both specialists and generalists. The Association of Consulting Management Engineers recognizes and publishes a Common Body of Knowledge Required by Professional Management Consultants which applies to general knowledge needed by all consultants. The Common Body study states that one of the main difficulties in developing a description of the current nature of management consulting is the lack of recognition of what is meant by and included in the term "management." The general usage of the term makes it difficult to define the nature of consulting work.[6] The Association of Consulting Management Engineers concludes that the basic nature of management consulting requires an understanding of the overall picture of management. Specialization in a particular management function such as personnel or plant expansion requires

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[5]See for example: Small Business Management Series No. 29, Management Audit for Small Manufactures; and Series No. 31,, Management Audit for Small Retailers, published by the Small Business Administration, Washington, D. C.

[6]Association of Consulting Management Engineers, Inc., Common Body of Knowledge Required by Professional Management Consultants (New York: Association Planning Committee, Association of Consulting Management Engineers, Inc., 1957), p. 8.

skills beyond those set out in the Common Body of Knowledge.[7] The problem of the definition of management will not be considered here. It is assumed that a useful analysis of management consulting and its relationship to management can be attained by accepting whatever definition is used by consultants.

The Nature of Management Consulting Responsibilities and Subject Matter

Management consulting is available to any type of organization and to any function within an organization. Consulting services are performed by request of management of an organization and the responsibility for the results of an engagement is to management. No responsibility to outside parties is assumed and indirect responsibility only to other organization employees is assumed. Management consultants are hired by top management and their reports go to top management.

Special services of almost any type will be rendered when requested and when the appropriate consulting skill is available. The American Management Association Directory lists the following classifications of management consultants:

Financial Management
General Management
Insurance Management
Manufacturing Management
Office Management
Administrative Services
Packaging

[7] Ibid., pp. 8-9.

Personnel Management
Research and Development
General Consultant in Management
Consultants in Other Fields.[8]

The Association of Consulting Management Engineers classifies consulting services into four broad areas of research and development, production, marketing, and finance and control.[9]

The subject matter of most management consulting engagements is one part of an entire organization. Emphasis is upon one segment, such as production management rather than total organization management. Consulting tends to be limited to a known or suspected problem area and management must make the original decision whether to obtain outside assistance. One suggested approach to management consulting is to define it as broader in nature than just finding and curing poor management. This school of thought defines the consulting function as "to analyze the 'state of the enterprise' -- to determine its current position and preparedness for the future in terms of its particular evolutionary pressures."[10] This approach does not advocate "audits" of management as a whole so much as the necessity of using a total enterprise point of view when analyzing a specific problem. Special emphasis is placed

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[8]H. G. Trentin, "The CPA in Management Services: A Survey and Projection," Management Services. V. 3, No. 2 (March-April, 1966), p. 17.

[9]Association of Consulting Engineers, Inc., op. cit., pp. 8-9.

[10]Samuel M. Greenhouse, "Management Consultants: Analysts or Counselors?", Advanced Management Journal, V. 30, No. 1 (January, 1965), p. 53.

upon external forces influencing an enterprise.

As in management services by public accountants, success of consulting depends upon the fact that outside experts and independent viewpoints are useful to management. The inherent weaknesses of self-appraisal, correction, and improvement, which lead to the need for independent assistance, have led to both management consulting and financial audits.[11]

The Nature of Management Consulting Services

Management consulting service is best described as assistance to management in any way possible. Andreychuk suggests three roles in which the consultant may usefully serve his client: He may serve as an expert and establish and implement a system such as data processing; he may act as a resource man who makes suggestions to be followed up by client personnel; or he may serve as a catalyst to stimulate thinking and interaction.[12] When the consultant is engaged to solve a particular problem, Andreychuk divides the nature of serivces into the following three phases:

1. diagnose the problem
2. propose a solution
3. implement the solution program[13]

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[11] John R. Buckley, "Management Services and Management Audits by Professional Accountants," California Management Review, V. IX, No. 1 (Fall, 1966), p. 43.

[12] Theodore Andreychuk, "Psychology of Consulting," Management Services, V. 1, No. 1 (March-April, 1964), p. 54.

[13] Ibid., p. 57.

The first two phases are similar in nature to management auditing, although the service itself is so varied that not all is objective enough to be included within the audit concept. As previously pointed out in Chapter VII of this study, when the third phase of implementation is carried out, the consultant has lost a great deal of his independence. The consultant would have a vested interest in the newly implemented program which could influence his opinion in a subsequent engagement. Buckley points out that many management service engagements by Certified Public Accountants are often the result of client dissatisfaction with a management consultant.[14] The Certified Public Accountant is engaged because of dissatisfaction and the inability of a previous consultant to objectively review his own work.

The Nature of Management Consulting Standards

The standards by which the quality of consulting is evaluated are very general and are not universally applicable. The Association of Consulting Management Engineers has established certain basic skill requirements but it lacks any enforcement powers. No generally accepted standards of quality of service have been adopted. The predominant factor seems to be the satisfaction of clients and the reputation of a particular consultant or consulting firm. This lack of uniformity in consulting quality is consistent with the lack of uniformity of services performed. For purposes of this study, only the nature of the criteria

[14] Buckley, op. cit., p. 45.

used to evaluate evidence obtained in a consulting engagement will be considered further.

There is no formal, generally accepted body of management standards which can be used to interpret consulting engagement findings, although many principles of management have been developed. A few examples of consulting findings and recommendations appearing in current literature are cited here to illustrate what evaluative criteria can be used. The samples cited are from a case study of management consulting engagements in small business which was prepared at the University of Mississippi under a Small Business Administration grant.[15]

Specific economic criteria are usually not listed; however findings and recommendations usually imply certain types of criteria. Some of the recommendations made by management consultants were: (1) to determine the market potential of a new product by economic analysis of a market area including a market survey; (2) to establish general price controls as a means of obtaining an average price for raw materials and to protect supplies from extreme seasonal price fluctuations, (3) to conduct an economic analysis on the future of an industry and the client's relative position within the industry. From this analysis the client's plans for production, diversification, etc. could be developed. Many recommendations of consultants refer directly to the skills of managing. These recommendations may apply to any type or level of management. Some examples contained in the previously cited case

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[15] Green, Downer, and Cerny, op. cit.

study are: (1) to improve or expand the client's advertising program; (2) to improve the organization of management and to formalize management organization by written specifications; (3) to develop or improve sales forecasting, production planning, and cost evaluation; (4) to increase or decrease the size of the sales force, management staff, or production crew; and (5) to improve production facilities. The general criteria of protecting ownership interests is applicable to most findings and recommendations listed above. Other recommendations directly affect ownership interests, such as diversification of product lines by expansion and, in some cases, diversification by merger or other forms of combination.

Summary of the Nature of Management Consulting

Management consulting is a form of service to management; it is a form of outside assistance to management. It seldom accomplishes anything that could not have been accomplished by management itself with the proper quality staff and the proper approach. This is evidenced by the fact that the potential benefits of consulting are greatest in small businesses with inadequate management staff and skill.[16] An exception to the above is the fact that an external opinion without a particular internal bias and with fewer limits on alternatives can be useful to management.

[16] Henry DeVos (ed.), Management Services Handbook (New York: American Institute of Certified Public Accountants, Inc., 1964), p. 2.

Consultants usually deal with specific problems of management that have already been partly identified and the results of an engagement generally recommend some changes which the consultant helps to implement. The implementation phase of an engagement lessens the independence for future engagements and would tend to reduce the potential benefit of external assistance in solving future problems. The growth of management consulting and the increasing management acceptance of external advice can be interpreted as a measure of the success of consulting.

If management consulting is to be considered a part of the broad concept of management auditing -- and it is often referred to as management auditing in the literature -- then it is a very informal audit approach. Many of the characteristics set out in this study are present, but not consistently applied in all consulting activities. The most important difference between management auditing and consulting is the emphasis upon collection of objective evidence in auditing and rendering an opinion or recommendation based only upon this evidence. Management consulting literature indicates that reports and recommendations by consultants are often based upon opinions from outside sources and expertness not related to the current engagement. In those instances when management is dissatisfied with consulting results, it may well be due to the lack of objective evidence supporting the opinion and recommendations.

The variation in scope, subject matter, and work performed makes uniform application of a set of consulting procedures difficult.

No well defined set of standards for consulting practice exists except the vague standard of successfully assisting management. No specific criteria are uniformly used to evaluate evidence obtained in a consulting engagement; however, as seems to be generally true in management auditing, when some useful service can be performed and is in demand, the necessary criteria will be developed. What is lacking in management consulting is not so much criteria for interpreting findings as a uniform application of these criteria.

The two following lists summarize what appear to be the more important requirements and limitations of successful management consulting.

Requirements:

1. management must accept the review and must cooperate with the consultant.

2. a specific definable problem must exist upon which the consultant can concentrate his effort.

3. the engagement must result in some improvement in the form of recommendation for improvement.

4. the external point of view must be present for useful results.

Limitations:

1. no uniform set of procedures and standards are applied which will result in similar conclusions by different consultants.

2. consulting is useful in specific problems rather than general evaluation when no problem exists.

3. when management is given direct assistance, future independence is weakened.

4. consulting is limited to those areas selected by management and results often depend upon the expertise of the consultant rather than objective evidence.

Management Audits by the American Institute of Management

The American Institute of Management was formed in 1948 to make available a systematic technique of management appraisal; to apply this appraisal technique to organizations; and to publish the results of these appraisals.[17] The Institute publishes an annual listing of those companies which it rates as excellently managed as well as detail reports on certain selected organizations.[18] The range of the Institute's clientele is not limited to business organizations; management audits have been applied to such diverse organizations as the Roman Catholic Church, Pennsylvania Military College, the cities of Mobile and Birmingham, Alabama, and the British Crown Colony of Hong Kong.[19] However, most management audit effort is directed toward large corporate businesses.

The management audits of the American Institute of Management have been both highly praised and sharply criticized by writers in the management and investment fields. The purpose of this brief analysis of the Institute's audit activities is to compare the approach, techniques,

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[17] Jackson Martindell, The Appraisal of Management (New York: Harper & Brothers, 1962), pp. xiv-xvii.

[18] American Institute of Management, Manual of Excellent Managements (New York: American Institute of Management, 1954), pp. 4-5.

[19] Martindell, op. cit., pp. 174-182.

and evaluative criteria used with those developed for management auditing in this study. Also the requirements and limitations of the successful application of the Institute's appraisals will be considered as they apply to management auditing. For clarity in presentation, the activities of the Institute are referred to as management appraisals rather than management audits.

The Nature of Appraisal Services by the American Institute of Management

The objectives of the Institute's management appraisals are: (1) to improve management by providing public recognition of good management and good management techniques; and (2) to enable Institute members to more accurately judge management performance of a specific company by comparing it with the performance of other companies audited.[20] The approach of the appraisal apparently varies with the amount and type of information available about the company to be appraised. Organizations are selected for appraisal on two bases: (1) those companies in which a management appraisal would be of educational interest to Institute members, and (2) those organizations for which a management appraisal has been requested. When an appraisal is requested, the requestor must bear the cost.[21] The author of a Fortune article has suggested that organizations making grants to the Institute or purchasing reprints of

[20] American Institute of Management, op. cit., pp. 4-5.

[21] Ibid., p. 96.

full appraisals "are permitted to say a great deal about the text" of the report.[22]

The basic approach of these appraisals is to collect evidence, evaluate the evidence, and form an opinion. An attempt is made to obtain information from the appraised company so an "inside audit" can be performed.[23] The primary source of this inside evidence is a 301 item questionnaire which is answered by executives of the client company and supplemented with general observations. If the 301 item questionnaire is not completed, a shorter 71 item form may be substituted.[24] A 1954 study of the activities of the Institute points out that in the event a company refuses to fill out either questionnaire, a company may be analyzed and "rated on the basis of published financial data, supplemented by press clippings and other library material."[25] The Institute contends that any company listed on the New York Stock Exchange can be rated from published data, the equivalent of an "outside audit."[26]

The evaluation of evidence and the final opinion thereon are admittedly subjective in nature. Answers to the questionnaires, interview data, and other public information about the client are reviewed by an

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[22] Daniel Seligman, "Mr. Martindell's Curious Institute," Fortune, V. LIV, No. 5 (November, 1956), p. 252.

[23] American Institute of Management, op. cit., p. 96.

[24] Seligman, op. cit., p. 252.

[25] Ibid.

[26] American Institute of Management, op. cit., p. 96.

auditing committee. Each member of the committee reaches an independent evaluation, then, acting as a group, a final agreement is reached. A point rating system is used in which 10,000 points is perfect and 7,500 points is the minimum for an excellently managed company. The audit committee through much discussion and argument agrees on a final point value to be assigned.[27] Despite the numerical system of scoring, the final results are quite subjective in nature.

Nature of Standards Used by the American Institute of Management

Evidence collected in an appraisal engagement is classified into ten categories and evaluative points are assigned to each of these categories. The categories used and their relative importance to the total appraisal are as follows:

Executive evaluation	2,400
Sales vigor	1,400
Production efficiency	1,300
Fiscal policies	1,100
Directorate analysis	900
Research and development	700
Service to stockholders	700
Health of earnings	600
Corporate structure	500
Economic function	400[28]

The Institute's opinion usually does not include the specific score of a client in each category, however, a few detail reports do include the specific point allocation.

[27] Seligman, op. cit., pp. 247-248.

[28] Martindell, op. cit., pp. 4-10.

The criteria used to evaluate evidence are primarily subjective in nature. The above ten categories were developed by the Institute's founder and apparently are applied in accordance with his objectives. The evidence collected for evaluation is also primarily of a subjective nature. In the final analysis, the only criteria that may be used to evaluate the quality of appraisals by the Institute are those of success and usefulness to the report readers. As previously pointed out, the acceptability of these appraisals has been questioned.

Summary of Management Appraisals by the American Institute of Management

The management appraisals by the Institute are one of the few examples of appraisals or audits which result in an opinion on management as a whole that is intended for outside interests. The appraisal activities resemble those of management consulting, except that they appear to be broader in nature. The reporting function is similar to that of the independent financial audit, except that the degree of reliance is much less. From the limited review used here and from analysis of these management appraisals, they are not auditing as defined in this study.

Appraisals by the American Institute of Management are more in the nature of editorial criticism as described in Chapter III than auditing. Adequate objective evidence is lacking and is compensated for by subjective evaluation. The appraiser does not have control over the selection of evidence; rather whatever evidence is publically available is often used. The use of subjective evidence and evaluation is apparent in the phase in which a committee decision is required for the final evaluation. Evidence collected and evaluated as well as the criteria used to evaluate the evidence are not objective enough that any uniformity could be expected among different individuals or groups appraising the same organization. Critics of the Institute point out that personalities of both the Institute and the client may have an effect on the outcome.[29]

Comparison of these appraisals to other approaches to management auditing further emphasizes the importance of management acceptance and cooperation in any type of management audit. Without this cooperation and the collection of adequate evidence, the resulting conclusions are the result of editorial criticism rather than audit. While there is much interest in improvements in the material available to appraise management, the subjective approach used by the American Institute of Management has not had wide acceptance. It appears that the demand for an overall evaluation of management is a demand for a more uniform, objective approach. As pointed out in previous chapters of this study, there is an inverse relationship between the scope of management audit subject matter and the objectiveness and reliability of the resulting audit opinion.

Audits by State and Federal Bank Examiners

The activities of State and Federal Bank Examiners are closely

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[29] Seligman, op. cit., p. 254.

related to the activities of internal auditors and governmental auditors previously analyzed in this study. Since banks have a greater social responsibility for their operations than most other business organizations, bank examinations and subsequent reports are needed to protect the public interest. Bank examiners have a greater responsibility to the public than most internal auditors and a closer relationship to both business and the public than most governmental auditors.

There are two major types of bank examinations currently conducted. The first is the directors examination conducted by representatives of a bank's board of directors and reporting directly to the directors. Directors examinations are not considered in this analysis since their activities are consistent with those of other internal auditors analyzed in previous chapters. The second type of examination is conducted by regulatory agencies of the State or Federal government in the interest of protecting the general public as bank depositors. The activities of this group are considered here for comparison with other types of management audits previously analyzed.

The Nature of Bank Examination Services and Subject Matter

In a recent book on detecting bank frauds, the nature and duties of bank examiners are described as follows:

> Examiners devote substantially all of their time to the appraisal of the assets, appraisal of management and their conformance with banking law and regulations -- primarily to determine the degree of adherence to safe and sound banking

policies and practices.[30]

The author points out the limited reliance that can be placed upon examinations made periodically by State or Federal employees because these examinations deal primarily with internal consistency and propriety of bank records. Examination procedures used by bank examiners are not adequate for giving an opinion or bank financial statements.[31]

The primary purpose of State or Federal bank examinations is to appraise bank managements' compliance with applicable laws and regulations and adherence to sound banking policy. The point of view in bank examinations is that of bank depositors, the consumer, and regulatory agencies rather than other interests such as investors. In recent years comparisons between bank examinations and external financial, "opinion," audits have been made. One such comparison describes examiners as follows:

> Examiners in general, spend more time on investment portfolios and policy, detailed credit analysis of loans, appraising the effectiveness of management, and determining the adequacy of banking services to the community.[32]

One point of view is that both the external auditor and the bank examiner have the same ultimate general objectives; those of appraising the

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[30] Lester A. Pratt, Bank Frauds: Their Detection and Prevention (second edition; New York: The Ronald Press Company, 1965), p. 26.

[31] Ibid., pp. 25-27.

[32] Editorial, "FDIC Chairman Discusses Bank Audits and Examinations," The Journal of Accountancy, V. 120, No. 6 (December, 1965), p. 18.

conditions and results of operations in banking institutions and ascertaining whether banks are being managed in a competent and satisfactory manner.[33] Another approach, often taken by the same authors or speakers, is that the basic audit approach and objectives are quite different. "The examiner and the auditor, because of the basic differences in ultimate objective, do not even approach their tasks from the same point of view. They have been trained to look at the same loan portfolio, the same deposit ledger from far different perspectives."[34]

The two above views are not inconsistent because the general objectives of appraising conditions and results of operations and whether management is satisfactory applies to any type of audit examination. Specific objectives -- financial statement presentations or compliance with applicable laws and regulations -- differ between the two audit groups. The external auditor's point of view is that of all interested parties while the bank examiner is primarily concerned with the general public as depositors and as represented by governmental agencies.

The Nature of Bank Examiners Responsibilities and Standards

Banks and other deposit and loan institutions are subject to regular examination by government agencies. Langston lists some of the applicable regulative agencies as the Comptroller of the Currency,

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[33] Ibid.

[34] Editorial, "The Importance of Bank Audits," The Journal of Accountancy, V. 120, No. 1 (July, 1965), pp. 21-22.

State Bank Departments, Federal Reserve Banks, Federal Deposit Insurance Corporation, and Clearing House Associations.[35] Examiners are directly responsible only to their respective agencies and their reports go only to these agencies. All other responsibilities, such as to the examined bank and the general public, are indirect. Standards for judging the quality of examinations are those established by the agencies for their employees and are only indirectly concerned with satisfying banks and the general public.

The criteria used to evaluate evidence obtained in bank examinations are the laws and regulations applicable to bank operations. Banks are required to operate in the public interest and standards from the categories previously discussed in this study -- social, economic, legal, and reasonable management skill -- are included in banking regulations. Bank examiners do not emphasize standards for profitable operations set by owners of banks. In many cases there is a direct conflict between ownership desire for increased profits and legal requirements used as criteria by the examiner.

Summary of the Nature of Bank Examinations

Banks have a responsibility to their customers and their community which is greater than most other private business. Since banks have the power to create money they have become almost government operated businesses using private capital. The public interest is

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[35] L. H. Langston, Bank Accounting Practice (New York: The Ronald Press Company, 1937), pp. 500-501.

protected by extensive regulation and by regular compliance examinations. Compliance examinations, which are "a primarily qualitative analysis, aimed at developing the value of holdings (assets), their soudness, the legality of bank actions, the soundness of capital, and the quality of management,"[36] are a type of management audit. As bank managements' choices are more limited, bank examinations and the compliance portion of management audits become more feasible. Also, as business is more highly regulated, compliance becomes a more important part of a bank management audit. It appears that management audits would be more feasible in highly regulated, highly structured organizations. Also; as all business is subject to increasing governmental regulation, management auditing from a compliance point of view should become more feasible.

The success of bank examiners' applications of management audit techniques is due in part to the acceptance of examination by management. Bank management operates with the knowledge that most decisions will be subject to audit by some external group. Examination of bank management's actions is also acceptable and demanded by the general public to protect its interests. These demands are channeled through government agencies, however, without these demands, this type of management audit would probably not be conducted. The results of bank examinations are generally not made

[36]Editorial, The Journal of Accountancy (July, 1965), op. cit. pp. 21-22.

publicly available as is true of most other types of management audits considered in this study. For this reason, bank examinations are of little direct value to stockholders or potential investors.

Other Approaches to Management Auditing

The consideration of other approaches to management evaluation through auditing is necessary for two reasons: (1) to illustrate that the institutional -- group -- approach in this study does not cover all activity in the area of management auditing, and (2) to point out that the demand for management auditing is such that attempts are being made to find a useful approach. Two examples of other approaches to management auditing are briefly described and related to the concept of management auditing.

The first example deals with the application of management auditing by students to the results of business games as played by students in University management classes.[37] In these experiments, management auditing -- "statement of opinion by a CPA with regard to the performance of the management function"[38] -- is introduced as a means of evaluating the "playing of the game." Student auditors are to evaluate management methods used by other students while

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[37]Neil C. Churchill and Richard M. Cyert, "An Experiment in Management Auditing," The Journal of Accountancy, V. 121, No. 2 (February, 1966), pp. 39-43.

[38]Ibid., p. 39.

playing management games. Accepted principles of management are used as the basis for evaluating audit evidence. The emphasis in these student audits is upon the decision making process and procedures used by student managers rather than the correctness of their judgment. The conclusions drawn from these experiments are that the process of management can be audited independently of the results management attains; a broad knowledge of management is not ncessary to evaluate management methods and procedures; and, when adequately documented with objective findings, the results of a management audit are useful to the top management of the "Game Firm."

In relation to the concept of management auditing developed in this study, these experiments support several points raised earlier. The feasibility and usefulness of management audit opinions for outside third parties was not considered even though it is implied in the definition used for management auditing. Results of the student audits were tested against the opinions of the board of directors of the game. These directors consisted of businessmen and faculty who reviewed the management audit report with student management and student auditors. Most current management audits are internal, crossing management levels rather than as external reports to outside interests. As developed in other chapters of this dissertation, outside, third party reliance is not a prerequisite for successful auditing.

In these experiments, accepted principles of management were deemed adequate as criteria for interpreting audit evidence; however, the best results from management audits are attained when adequate, objective support is cited for audit findings and conclusions. This is consistent with previous findings in this dissertation that successful management audit reports need to include specific findings. Accessibility to evidence and acceptance by management that their activities are subject to audit is also a prerequisite for management auditing. These factors existed in the experimental situation since students in courses expect and accept the fact that their work is to be evaluated. The experiments do not provide any measure of the effect of this factor in less controlled situations. As previously brought out in this study, as a business becomes more controlled and structured through various forms of regulation, a management audit is more feasible. In these controlled, structured, classroom situations a management audit can be useful in evaluating methods and procedures used.

The second example of other approaches to management auditing involves the use of management audit procedures in the audit of a firm of Certified Public Accountants. The following illustrates this example:

> Also in connection with the firm's long-range planning, three eminent accounting academicians, Mr. Neil Churchill of Carnegie Tech, Mr. George Sorter of the University of Chicago and Mr. Dennis Grawoig of Georgia State have been engaged to conduct a "management audit" of the policies and operating procedures of our firm during the forthcoming summer. These gentlemen are believed to be outstanding in their field and are familiar with the public accounting profession having been both employees and consultants. It is contemplated that approximately three man months will be required to complete their engagement. They will report on firm objectives, the

> characteristics of our market, our firm image with clients, prospective clients, lost clients and others, and will review other operating policies and procedures. We are looking forward to this type of audit which could very well be the type of audit the public accounting profession will be carrying out for its clients in the not too distant future.[39]

From this project, regardless of its ultimate success, it is apparent that when management is willing to be audited a management audit can be undertaken. Factors such as the criteria by which to evaluate audit evidence, and the relative formal structure of management's activities may effect the quality of a management audit but they do not prevent its application. As in previous examples of various types of management audits, the final report is to be issued to management rather than outside interests.

Management Audits by Non-Audit Groups

This section considers the general approach to management reviews or audits by outside interested parties such as bankers, financial analysts, other stockholder representatives, and government agencies interested in protecting investors. Much of the current demand for some form of management audit comes from these groups who need some way to evaluate management. The following analysis considers bankers as either present or future creditors, but the same reasoning will also apply to those interested in stock investment or consumer protection.

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[39] McGladrey, Hansen, Dunn & Company, Highlights and Sidelights (Unpublished Company Letter, May, 1966), p. 1.

Bankers must evaluate the management of any organization to which they extend credit. Liquidity, cash flow, and collateral are important factors, but continued successful, profitable operation is the ultimate criteria in any loan commitment. Both long-run and short-run liquidity are dependent upon management actions which guide the organization. Dewing has written that with excellent management any business will survive but with poor management any business will eventually fail.[40]

Bankers take a point of view that will best protect their own interests when evaluating management. It may be argued that bankers are operating in the interest of third parties -- depositors -- or that financial analysts act in the interests of their clients, however, the major objective is to improve their own operations by improved service to their customers. The banker has little responsibility to the management he evaluates. The nature of management auditing and of all auditing requires at least a two way responsibility; that is, a fair objective evaluation from the point of view of the report user. The auditor cannot have an interest in the outcome of the audit if he is to perform a useful function.

It is concluded here that these non-audit groups are primarily users of management audit reports and by being report users cannot effectively conduct the audit. Management reviews and evaluations are an integral part of the operations of many non-audit groups but these reviews are not management audits as developed in this study.

[40]Arthur Stone Dewing, The Financial Policy of Corporations (fifth edition; New York: The Ronald Press Company, 1953), II, pp. 1216-17.

CHAPTER IX

EVALUATION OF FINDINGS: CONCLUSIONS AND RECOMMENDATIONS

The objective of this study has been to describe, organize, and analyze the concept of management auditing as it currently exists in order to develop conclusions about this concept and its future development. The research was conducted primarily from an audit point of view and the conclusions and recommendations in this chapter also reflect this point of view. The assumptions underlying the research were that there is a broad concept of audit which includes both financial and management auditing and that an analysis of auditing literature and practices will produce identifiable features of this concept which can be classified and summarized to identify the nature of such auditing; its requirements and its limitations.

The research for the study was conducted in two phases and the preceding chapters follow this format. The first phase is an investigation of the general nature of auditing, both past and present, and its relationship to general critical theory and forms of management criticism. The general nature of standards and their use as professional judgment criteria are also considered. The second phase is an investigation of the management audit practices of several groups currently performing this type of service. In this chapter the research findings are evaluated and conclusions drawn about the nature of auditing in general and management auditing specifically. These conclusions lead to recommendations for the future development of management auditing and the type of future research needed.

Major Research Findings and Conclusions

Littleton defines a concept as a series of related ideas[1] and the investigation of a concept can result only in the identification and clarification of some of these related ideas. Many of the limitations of successful application of management auditing presented in this study apply equally well to the findings and conclusions reported in this chapter. Notably, the lack of conclusive factual evidence and the absence of accepted criteria by which to evaluate the evidence obtained. In auditing, the final report is usually qualified as being based upon the evidence obtained and certain identified standards. The same qualifications apply to the conclusions and recommendations in this chapter; that is, they are based upon the evidence obtained in the research of the preceding chapters. The findings about the general nature of auditing and the requirements and limitations of management auditing are summarized in this section. These findings and others are also used as a basis for the subsequent conclusions and recommendations.

The General Nature of Auditing

Current practices of external auditing, government auditing and internal auditing can be traced back to a common historical origin. Auditing as the service of an unbiased review dates back as far as we

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[1] A. C. Littleton, Structure of Accounting Theory (Madison, Wisconsin: American Accounting Association, 1953), p. 148.

have written records, but the basis for current developments stems from the period of the English Manor System. Auditing is a control function whose basic objective is to improve the control over certain organization units. The methodology of auditing has been compared to the scientific method and is very broadly described as collection of evidence, evaluation of evidence, and drawing conclusions from this evidence. As currently practiced, auditing applies to the direct or implied representations at all levels of an organization. Auditing can be directed twoard any economic or financial plan, policy, procedure, activity, or report, and the final audit report, in which an opinion is formulated, contains direct or indirect recommendations for improvement.

Relationship of auditing and critical theory. There is general agreement that auditing is critical in nature rather than constructive and that auditing is a particular form of criticism which emphasizes opinions based upon objective, factual evidence rather than unsupported personal opinion. As such, auditing is defined as one part of the more general area of critical theory. The ultimate goal of criticism, including auditing, is the full, evaluated apprehension of a subject. This apprehension may rely heavily upon description, but full apprehension must also include evaluation.

The requirements for all forms of criticism are a clearly stated objective, appropriate analytical procedures, and understandable, useful reports. The objectives of criticism and auditing vary; however, the broader the scope of the objectives, the greater the potential usefulness of the results and the fewer the available, appropriate procedures. On the other hand the narrower the scope of the objectives the lesser the potential usefulness of the results and the greater the number of appropriate procedures. Critical procedures should originate from the objective of the criticism rather than the objective being limited by a set of available procedures.

Critical analysis and auditing are more appropriately based upon an external frame of reference. Criticism may be applied to any subject, but auditing is appropriate only when applied to the economic and financial aspects of an organizational unit. Criticism may be based upon personal, biased, evidence and may emphasize the opinion rather than the supporting evidence. Auditing, on the other hand, is a part of investigative criticism which must have objective, evidential support for any opinions.

It is concluded from my limited research in critical theory that auditing is one phase of the general field of criticism and audit theory and practice should be consistent with critical theory and practice in other areas. However, auditing is but one small part of the field of criticism and certain requirements in the activities of evidence collection, evaluation, and opinion formation are more restrictive in auditing than in general criticism. Criticism, to be considered auditing must be applied to the economic or financial aspects of an organization and meet the restrictive evidence requirements.

The broad concept of audit. The findings in Chapter II and III lead to the conclusion that a concept of auditing including both financial and management auditing currently exists. What is lacking is the recognition of this general concept by various audit groups and the utilization of this general concept in most auditing literature. No exact definition of this audit concept is possible but some of the significant features can be identified.

Auditing is a critical service function and its contribution is in the form of control and improvement through either explicit or implicit recommendations. It is the critical examination of some identifiable organization unit and the most consistent current usage applies only to economic and financial areas of these organizations. The audit methodology is flexible but it requires the use of objective, factual evidence. The nature of this evidence is dependent upon the particular audit objective. Auditing can be directed at any level of an organization and the audit report can be used either internally or externally. The audit can be applied to either things or actions and to problems of fact or of value, however, an independence from the conduct of the operation audited must be maintained. As in all social sciences, the audit evidence is seldom conclusive enough for certainty and audit results are reported in the form of opinions and recommendations. The auditor's judgment must be used to decide what opinion should be issued if, in fact, the evidence is adequate for any opinion.

The Nature of Management Auditing

Management auditing, as a part of the general audit concept, is included in the above conclusions, the research findings on audit responsibilities, subject matter, service, and reports are set out in Chapters V through VIII of this study. The significant findings and conclusions about the requirements and limitations of the successful application of current management auditing are summarized here.

Requirements for successful management auditing.

1. Management must want an audit or be required to submit to audit; management must cooperate in the audit application.

This requirement is met in all current practices of management auditing although the reasons vary. Government agencies are required to submit to management audits and agency management accepts the fact that their activities are subject to critical examination. Management audits in private organizations are conducted only at the request of management. Even though management may accept the responsibility for operating in the public interest, it is doubtful whether management audits of private organizations will expand without strong external pressure from the government, stock exchanges, stockholders, etc. It is generally agreed by all management auditors that management cooperation is a necessity.

2. The auditor must be independent of the actual performance of the operation audited and must maintain an objective, unbiased point of view.

The degree of audit independence is sufficient as long as the auditor has no responsibility for operations and has no vested interest in the audit results. The auditor must be qualified to apply audit methodology and the audit opinions must be based upon an objective evaluation of factual evidence. The auditor must have access to all necessary evidence and must be the one to decide when evidence is adequate. In most cases audit evidence is accumulated in some form of working papers.

> 3. To obtain useful audit results management audits must be applied to situations in which management is highly structured.

Management structure includes clearly defined objectives, policies, and procedures which the auditor can use as a basis for evaluating audit evidence. Compliance audits based upon established rules and regulations are currently the most feasible application of management auditing. These regulations may be established by law, ownership interests, or management itself in the form of plans and policies. In connection with this requirement it is also necessary to accept some criteria other than cost saving or dollar profit as a measurement of management's success before management auditing can be successfully applied. This is currently applicable in government operations and in nonprofit private organizations.

> 4. The audit subject must be narrowed to a specific problem for which audit objectives can be clearly defined and for which a detail audit program can be developed to produce measurable results.

Evaluations of overall management are not attempted in most current audit practices nor do they seem to be practical with current audit approaches. Current management audits begin with a general survey from which specific problems are selected for detailed audit examination.

A common basis for problem selection is that of areas in which measurable dollar savings can be found. Another approach to this requirement is to select major management objectives to be subjected to detail audits rather than audit all major and minor objectives.

A second factor in requirement four above is that the organization structure of most audit groups is such that most of the detail evidence collection is done by less experienced, less qualified auditors. The use of junior auditors to conduct audits provides them with the necessary audit experience but it also requires the use of rather formalized audit procedures and a consistent audit approach through the use of some type of audit program. The audit subject matter and audit objectives must be identifiable to the degree necessary to prepare audit programs and to review the work of less experienced auditors.

5. The results of management audits must be reported and the report format must be flexible enough to include the audit procedures used, findings, conclusions, and recommendations for improvement.

The objectives of management auditing must include the issuance of an accurate and useful report regardless of the conclusions reached. The report may be informal such as a letter to management or it may be formal such as the reports of the General Accounting Office. Much of current management auditing is limited to deficiency reporting and the acceptance of such auditing is not as enthusiastic as it would be with more inclusive audit reports.

The amount of detail included in audit reports varies and generally the more subjective the criteria used to form report opinions the more detail about audit findings and criteria used will be included in the final report. The historical development of the external auditors opinion on financial statement presentations suggests that as management standards and management audit procedures become more generally accepted, less detail will be included in management audit reports. As the chapter on criticism points out, when evaluative criteria are not clear, the examination's findings and conclusions may have to be made clearly contingent upon the criteria used.

Limitations of successful management auditing. The five following factors were found to limit the current success and potential success of management audits. Future improvement of management auditing will come from reduction of the restrictions imposed by these limitations.

1. Management audits are usually limited to audits of line management and middle management; the audit conclusions and recommendations are usually available only to top management of the audited organization.

It is established in Chapter I that there is a demand for more information by which an organizations overall management can be evaluated. Current management auditing practice does not make this overall evaluation nor are audit results useful in this evaluation. Most current audits do not examine overall company management and current audit reports are not available to external interests. The lack of adequate criteria by which overall management can be evaluated and the lack of sufficient external pressure for such evaluations are two reasons for this limitation.

Auditors of the General Accounting Office have the authority to audit and give opinions on overall agency management but this is seldom done due to a lack of evaluative criteria and appropriate audit procedures. The Army Audit Agency issues an overall opinion on management but it is restricted to selected major missions only.

> 2. Current management audits are limited to specific problems and deficiency identification rather than overall evaluations and audit benefits are interpreted from a negative point of view.

Much of the comment in one above also applies to this limitation. Current management audit practice results in the unfortunate stigma of "bungling management." Audits are limited to specific problems and deficiencies for two reasons, first the demand for overall positive and negative evaluation is not sufficient to make these audits economically feasible and second the available management audit procedures and techniques make it impossible to consider total management. For example, in audits by the General Accounting Office, hundreds of man-days are needed to isolate and substantiate limited findings. The application of this approach to all management of an agency would not only be uneconomical, it would be humanly impossible. The Army Audit Agency applies detail audit procedures to major missions of an installation and reports an opinion of management's accomplishment of the major mission. Reduction of this limitation may be possible by further identification of major missions of organizations and the development of audits of these missions.

3. Current management audit techniques and standards of audit quality are inadequate for uniformity and general acceptance of audit practices.

The success of present management auditing often depends upon the skill and knowledge of the individual auditor rather than the audit procedures used. The necessary skill and knowledge are not generally known and the audit report user cannot judge this skill except through the acceptance of audit results. Audit reports vary in quality and the time and effort needed in a management audit are not uniform. This type of limitation is usually reduced as more experience is gained by the auditors and those who rely on audit reports.

4. Generally accepted principles or standards necessary to evaluate audit evidence are not well defined nor generally understood by audit report users.

In current management auditing the auditor often develops and uses his own standards. The usual effect of this limitation is that the auditor must report his findings, conclusions, and the criteria used to reach these conclusions. More audit evidence is necessary for an opinion based upon subjective criteria than upon objective criteria if the report reader is to accept the opinion. This limit further restricts the economical feasibility of general evaluations of management. Compliance audits use agreed upon laws and regulations as evaluative criteria and this type of management auditing is more common. The lower the management level subjected to an audit, the more compliance with existing regulations and procedures can be used in the audit. Management auditing is more acceptable in Government agencies than in private organizations because these agencies are subject to more extensive regulation and can be more easily audited. Restriction of audits to compliance audits reduces the usefulness of audit reports as an overall evaluation of management.

Research on the background of standards presented in Chapter IV developed the findings that measurement of a subject usually precedes the development of generally accepted standards which appears to be the situation in current management audits. Chapter IV also points out that as a field such as management becomes more "scientific" more specific measurement standards are developed.

> 5. Management audit reports may include explicit or implicit recommendations for improvement but if the auditor assists in the implementation of these recommendations there is a loss of audit independence.

The research findings in Chapters VII and VIII point out that the implementation of suggested improvements is the practice of management rather than the review of management. If management is actively assisted by the auditor, he would not be independent in any future engagements because he would be forced to audit his own work, nor would he be independent in the current engagement because he would have an interest in the audit results. The loss of independence by the management auditor assisting management is analogous to the financial auditor's loss of independence when he assists the client in keeping records or preparing financial reports.

The Nature of Standards Used in Management Audits

One of the assumptions of this study is that if management audits are conducted, criteria exist to evaluate audit evidence and it is possible to classify the criteria being used. This analysis and classification will serve as a basis for future refinement of audit approaches. The research approach considered only the criteria actually used rather than trying to develop new criteria.

The research findings about the nature of standards leads to the conclusions that current management standards are measurement standards rather than computational, and include both technical standards and social standards, particularly as interpreted by law. Standards for management performance have evolved from a mixture of customary practices and legal requirements. These standards apply to both managerial actions and the objects which are the results of these actions. In a developing field such as management, measurement usually precedes the identification of generally accepted standards. As an activity evolves and becomes more refined, more specific standards are adopted.

Chapter IV also identifies five categories of standards that are used in various professional activities; social, legal, economic, controlling interests, and reasonable skill. These five categories were considered in the analysis of criteria being used in current management audits. The conclusions reached from this phase of the study are at best general. Standards do exist and are being used; however, their usage is so varied that a clear pattern could not be established. Social criteria used are primarily those interpreted by laws or those of an economic nature. Reasonable skill by managers is interpreted in terms of compliance with accepted legal standards and requirements of controlling interests for economically efficient operations. Most management audit standards are not generally accepted and are explained in the audit report to the extent the auditor believes necessary to justify his conclusions and recommendations.

The Audit Group Best Suited to Conduct Management Audits

The conclusion on the selection of management auditors depends upon the type of management audit to be performed. The first alternative considered assumes the audit report is to be used by outside interets, the second alternative assumes audit reports are to go to management, and the third alternative considers the situation existing in Government operations. If the user of management audit reports is to be the general public or some specific outside interest such as investors or creditors, then the management audit must be conducted by an external auditor. Whether these audits emphasize compliance with specified regulations or emphasize overall management evaluation, either Certified Public Accountants or management consultants would be best suited to conduct the audit. Management audits by Certified Public Accountants could be accomplished by an integration of current management services and current financial audits. CPA's already have an effective organization which can control the quality of such audits. More successful audits by management consultants would require more uniform procedures in the conduct of audits and the development of a stronger professional organization which can control audit quality. Either group would need to refrain from active assistance to the management audited. Certified Public Accountants are the better choice of the two as will be expanded further in the subsequent recommendation for a full service concept of auditing.

The second alternative of audit reports directed to management only more closely corresponds with the current status of management auditing. In this case any of the competent audit groups considered in this study could conduct such audits. The audits are the result of management requirements and management can select the appropriate auditor. If management wants an external point of view, an external group can be chosen, and if not internal auditors could be satisfactory.

The third alternative deals with government auditors, especially audits by the General Accounting Office. These auditors now report directly to Congress and are responsible only to Congress. Since Congress represents the general public's voice in government operations, the only possible improvement would be for the General Accounting Office to be made up of elected officials. Such a proposal would be unrealistic and possibly not even an improvement. Having public accounting firms conduct audits of Government agencies and report to the public and Congress would also not be much improvement over the existing arrangement. Management auditing in the Federal Government could be improved by more emphasis upon general evaluation of agency management of Federal resources and the evaluation of public interests served by Government operations.

Recommendations

The main recommendation developed from the research of this study is that future research into auditing theory and future refinements of auditing practices should be directed toward a broad "full service audit" concept. This approach should replace the current trend toward segmented audit developments which tend to contrast financial and management audits, internal and external audits, and opinion audits and management services. The full service audit applies to all economic and financial plans, procedures, activities, and reports of organizations, and results in flexible audit reports. Audit reports generated would include an opinion on financial statements, opinions on any other financial reports, opinions on management performance at various levels of the organization, and recommendations for improvement. All of the above information could be included in the report or any combination could be used as the circumstances demanded. Audit reports could be directed to the general public, selected outside interests, the board of directors, or to management, depending upon the audit requirements. This full service audit concept is the logical extension of the business audit approach currently suggested and applied by one public accounting firm[2] except there is no restriction of the ultimate audit report to an expression of opinion on financial statement presentations.

[2]Carl Tietzen "Changes in Public Accounting," The Journal of Accountancy, V. 105, No. 5 (May, 1958), pp. 86-87.

Many of the steps necessary to implement the full service audit are already being studied. Some examples are the expansion of the attest function to more financial data, conducting operational audits in conjunction with financial audits, and compliance features of audit reports on government related operations. The Certified Public Accountant already includes many of the full services in his financial audit but does not recognize these services as audit and does not accept as much responsibility for these services. Audits of other financial data and recommendations for improvements thereon can be readily incorporated into the present financial audits, but more development is needed before opinions on management performance can be issued.

It is recommended that a step by step implementation of the management audit phase be undertaken. The steps include the use of a flexible form of audit report in which the scope of the management audit can be identified and the resulting opinion contingent upon the audit scope. Opinions can currently cover compliance with applicable laws, meeting certain objectives such as budgets, and the adequacy of the system of financial control. Further developments in management measurement would eventually lead to an overall opinion replacing the piecemeal opinion.

Recommendations for Future Research in Management Auditing

1. It is concluded in this study that auditing is but a part of the general field of criticism. Further research in critical theory is needed to develop a sound, consistent theoretical basis for auditing theory as a type of criticism.

2. Behavioral studies about the effect of audits on management decisions and the effect of audit reports on external decisions are needed to determine the most productive audit approach. Similar studies are also needed to identify the factors necessary for management's acceptance of audit evaluation.

3. Management audit procedures need to be developed and tested.

4. More exact standards of management performance are needed and the effect the development of percise standards will have on management decisions needs to be identified and tested.

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VITA

John Herman Smith, son of Roy C. Smith and Ella W. Smith, was born on November 22, 1935, in Boonville, Missouri. After graduation from the Prairie Home Missouri High School in 1953, he worked as a stock clerk, printing press operator, and warehouse manager until entering the University of Missouri in 1957. He received a B.S. in Business Administration degree in 1960 and was an auditor for Price Waterhouse & Co. until 1962. In 1962 he entered the graduate program at the University of Missouri and received an A.M. degree in Accounting in 1963. He continued his graduate work at the University of Illinois leading to a Doctor of Philosophy in Accountancy. He was a part-time Instructor of Accountancy at the University of Missouri and the University of Illinois from 1962 to 1966, and at present he holds the position of Assistant Professor in Accounting at the University of Iowa. He was married to Susan M. Albers in December, 1960. He has three children, Margaret, age 6, Elizabeth, age 4, and John, age 2.