

# MANAGEMENT ADVISORY SERVICES

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## Developing Criteria for Internal Control Systems Review

In a prior article published in this department (May 1979), captioned "Additional Challenges for MAS Practitioners," it was noted that the Foreign Corrupt Practices Act of 1977 imposed on managements of publicly-owned corporations specific requirements for creation and maintenance of internal accounting controls. On the other hand, the related SEC Accounting Series Release No. 242, which calls for a review of accounting procedures, systems of internal accounting controls and business practices to facilitate compliance with the requirements of the Act, does not specify what should be involved in such a review.

In determining what should be encompassed by such a review (primarily a management responsibility) MAS practitioners can offer valuable assistance based on their skills in assessing the validity, relevance, efficacy and adequacy of applicable controls within the realities of a business environment. The writer sees the gradual formulation of needed criteria as a somewhat complex cooperative process calling for the active involvement of corporate financial and operating executives, CPAs in public practice and members of the academic accounting community, with guidance from members of the legal profession.

How could MAS practitioners participate in this process? An initial step might be one of cooperation with members of the academic accounting community to evaluate with them conclusions and recommendations derived from previously completed case work. (Such cases could have identifying information deleted.) While this MAS case work for relatively large clients would generally address only certain phases of business operations and the related controls, a composite of information de-

rived from such material may make available "field test" results as a substantive step towards working out tentative control evaluation criteria. The smaller MAS practitioners, more likely than their colleagues in larger MAS departments, might be called on to take an overall look at "what ails their clients." These smaller practitioners may be particularly qualified contributors to the contemplated concerted effort to define internal control review. This would be so because some pervasive conditions, such as client staff changes, operating factor changes and risks of management override of controls, may be relatively more visible from where they sit than for the CPAs serving larger organizations.

The compiling, screening, distilling and editing of such internal control information could, in the opinion of the writer, be made an important project of the MAS committees of the respective State Societies of CPAs. The conclusions could be transmitted to the MAS Committee of the AICPA for interfacing with the American Accounting Association and other applicable academically oriented bodies. On the assumption that the AICPA's Special Advisory Committee on Internal Accounting Control, formed to develop evaluation criteria, will continue in existence as an "action" committee, its members should be concurrently kept informed.

Focusing on a measure of commonality of approach among the "outsiders looking in" would be merely the beginning of a coordinated effort towards firming up viable internal accounting control evaluation criteria. The "distilled" field test results developed as suggested previously should be used as a basis for reaching a meeting of the minds with appropriate committees or task forces of the Financial Executives Institute, the American Management Association and the Institute of Certified Internal Auditors, all representing the insiders with the most direct

stake in criteria formulation. In that ongoing evolution, the MAS practitioners through their own organizations may help by direct input and as catalysts for plans to strengthen the reliability of important elements in the financial reporting process.

The foregoing notes reflect no more than the writer's tentative thoughts prompted by some of the questions left open in the Tentative Report of the AICPA's Special Advisory Committee on Internal Accounting Control. Comments as to the feasibility and practicability of the suggested approach would be welcome.

### Expanding Opportunities Auditing State and Local Governments

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There has been recently much legislative and interest group pressure directed at accounting, auditing and financial disclosures requirements of state and local governments. This attention has caused these governments to improve their accountability practices toward more effective reporting and disclosures to the users of their financial statements. Further, the governments have done some trimming and are becoming more fiscally responsible. This will profoundly affect the way state and local governments operate. These governments are faced with a potential scarcity of resources that makes it imperative to know precisely where they stand financially and what decisions they should make to fulfill their duty to provide needed services to the public. We can expect more state and federal legislation to increase the emphasis on financial audits of local governments. For example, the Municipal Securities Full Disclosures Act of 1977, and the State and Local Fiscal Assistance Act-1976 amendment (the revenue sharing act), require state and local governments to establish records and systems, and maintain internal controls procedures. It also requires that financial audits be performed in accordance with generally accepted auditing standards and certain grant conditions. For governments receiving funds from federal agencies un-

der federally assisted programs, the proposed single audit approach, published by G.A.O., may be applicable. When state and local governments accept funds under revenue sharing entitlements or federally assisted programs, they assume the responsibility of auditing the programs with the same thoroughness with which state and local programs are audited. Also, there is a growing thrust for more reliable financial information to be furnished to investors, federal grantors and taxpayers that provide financial resources to the governments. Thus, the shift of these public pressures on the state and local governments has greatly increased their need for more and better governmental accounting and auditing procedures, increasing the opportunities for CPAs who can effectively provide these added functions.

Governmental accounting offers a good solid practice growth area in which the accounting profession has an opportunity to render substantially increased services—on a basis which will contribute to the prestige of the profession and improve the financial credibility of the state and local governments.

The need for a closer scrutiny of governmental accounting practices was clearly pointed out during the New York City financial chaos in 1975. The recent Cleveland fiscal crisis further emphasized the need. Currently, the FASB and the National Council on Governmental Accounting (NCGA), state and local governments standards setter, are reviewing the present rules, state of the arts, and parameters of the accounting practices and procedures at the state and local levels. As a consequence, more and more CPAs can expect an increasing demand and a challenging opportunity for them to render their professional services in this area.

Governments have always used accounting. However, auditing is a newer phenomenon in government operations that is rapidly becoming more common. The G.A.O. has suggested that audits of state and local governments could determine whether they use their resources economically and efficiently. Here are some other reasons:

- An audit conducted with an understanding of and a sensitivity to government and the way it functions helps pinpoint the key information on

which certain decisions should be based and contributes to presentation of the information in a manner that facilitates decision making;

- A well-designed and executed audit can uncover deficiencies in the accounting system, and provide suggestions for improving the efficiency and effectiveness of that system;
- An audit provides elected officials and management with the opportunity to establish close working relationships with individuals who specialize in governmental financial management and accounting and who are familiar with the latest developments in the field;
- Qualified auditors can assist local governments and securities underwriters in presenting information used in marketing securities;
- An auditor can assure federal granting agencies about compliance with administrative and program requirements.

Proper accounting and effective auditing can alert government officials and taxpayers to potential problems early—in other words, in time to reveal the inefficiencies and uneconomical practices that can and should be corrected before serious operating deficits occur. The more effective and efficient government resulting from such auditing not only leads to less expensive government; it also enhances officials' reputations as prudent managers and good legislators and ultimately reduces the need for tax dollars.

Over the years, most people have considered the federal government the largest governmental employer and chief source of governmental expenditures. Since World War II, however, state and local governments have been expanding faster than the federal government.

A recent census reports approximately 78,217 local governmental units, broken down as follows: Counties—3,044; Townships—16,991; Municipalities—18,516; School districts—15,780; Special districts—23,886. Recent trends show that these numbers are relatively stable, except that school districts are declining due to consolidation, while the number of special districts is rising to meet new governmental service demands.

The 1972 census reported that the federal, state and local governments employed one out of every six