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GUIDELINES FOR ADHERENCE TO THE
GENERAL STANDARDS OF AUDITING

by

MARILYNN LEATHART HUGHES

A DISSERTATION

Submitted in partial fulfillment of the requirements
for the degree of Doctor of Philosophy in
the Graduate School of Business in
the Graduate School of the
University of Alabama

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1975

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CHAPTER I

INTRODUCTION

Nature of the Problem

The general standards of auditing, as presented in Statement on Auditing Standards: Codification of Auditing Standards and Procedures, are broad statements of the auditor's personal qualifications and the quality of his work.[1] They indicate goals or objectives the auditor must attain, but they do not provide sufficient guidance as to how such attainment is to be accomplished. The problem has been described by R. K. Mautz:

> The fault of our present standards is not that they exist; it is that they do not go far enough in fulfilling their purpose. They fall short of providing the guides that are urgently needed. Rather than abandoning our present standards, I urge they be supplemented and expanded. They tend to mark out the general areas in which guidance is needed; let us now develop more useful guides within these areas.[2]

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[1]American Institute of Certified Public Accountants, Committee on Auditing Procedure, Statement on Auditing Standards: Codification of Auditing Standards and Procedures (New York: American Institute of Certified Public Accountants, Inc., 1973), p. 7.

[2]R. K. Mautz, "A Critical Look at Generally Accepted Auditing Standards," Proceedings of the Twentieth Annual Institute on Accounting (Ohio: The Ohio State University of Business Research, 1958), p. 21.

Joseph L. Roth also has illustrated the need for guidelines in the area of auditing standards, especially when consideration is given to the probable expansion of the auditing function and related responsibility into areas such as forecasts of future earnings and evaluation of management controls.

> In summary, I expect that the audit function will come under more and more scrutiny and our procedures will have to be more specifically described and better understood. This means amplification of our literature to provide guidelines for meeting adequately our established auditing standards.[3]

Objective, Scope, and Limitations

The objective of the proposed study is to provide a clearer understanding than now exists of the general standards of auditing through an interpretive analysis of them. The means for attaining this objective is development of guidelines for adherence to the general standards, guidelines encompassing those presently in existence as well as those which should exist for a full understanding of adherence to the standards.

The scope of the analysis is limited to the general standards as presented in *Statement on Auditing Standards: Codification of Auditing Standards and Procedures*--training and proficiency of the auditor, independence, and due care in the performance of work. New standards will not be developed, but the meaning of the existing ones will be

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[3]Joseph L. Roth, "What's Ahead for the Auditors?" *The Journal of Accountancy* 128 (August 1969): 62.

expanded. Emphasis is on external auditing in the United States.

Research Procedure

The research procedure assumes the general standards as they presently exist do not provide the necessary guidance for adherence to them. In developing and presenting the necessary guidelines for adherence, the conceptual approach will be employed. Earle Edward Eubank has set out the steps involved in this approach,[4] and Mautz and Sharaf have adapted it to the area of auditing.[5] In accordance with their suggestions, the following research procedure will be used.

The first step will be gathering facts and other material related to adherence to the standards. The material gathered essentially is evidence of the guidelines presently in existence and thought regarding the guidelines which, in addition to these, ought to exist. It will be collected from the following sources of published information.

1. The American Institute of Certified Public Accountants--statements on auditing standards, other official pronouncements, Accounting Principles Board opinions,

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[4]Earle Edward Eubank, The Concepts of Sociology (Boston: D. C. Heath and Company, 1932), pp. 34-35.

[5]R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (Menasha, Wisconsin: George Banta Company, Inc. for the American Accounting Association, 1961), pp. 58-60.

accounting research studies and bulletins, and the code of ethics with its related opinions.

2. The American Accounting Association--publications and monographs.

3. The Financial Accounting Standards Board--publications.

4. The Securities and Exchange Commission--securities acts, regulations, and accounting series releases.

5. The federal government--publications related to auditing.

6. Judicial decisions--primary and secondary source material.

7. Accounting, auditing, and other literature related to the standards--papers presented at professional meetings, texts, books, and periodical articles.

8. Literature in fields such as the behavioral sciences and other social sciences.

The second step will be one of analysis and generalization on the basis of the material gathered. Such analysis and generalization involve classifying the material according to the standards affected, comparing and contrasting ideas, studying implications in the material, and drawing out evidence of guidelines for adherence to the standards.

The third step will be to compile the ideas regarding adherence into a frame of reference. This frame of reference consists of the meaning of the standards, indicators of adherence to them, and evaluation of adherence to the standards. From this step are derived the guidelines presently in existence.

Having formulated what the present guidelines are, the fourth step will be an examination and scrutiny of them to determine whether they provide a full explanation of adherence to the general standards. The examination is intended to point out possible deficiencies and questionable points, or those areas needing expansion. Basically, this step is the normative approach to developing what the guidelines ought to be or additional guidelines needed. It is an extension of the positive approach to developing what the guidelines are, and it involves abstraction, introspection, invention, and logical reasoning on the part of the writer.

The fifth step will be a blending of the existing guidelines with the developed ones which ought to exist for a full set of guidelines.

Method for Developing the Topic

The topic will be developed in five chapters. First, the historical development of the general standards, obtained from a study of auditing literature, will be presented. This history is intended as a demonstration of the standards' existence in the accounting profession before their formal statement and as a description of the major influences on their development and evolution.

Secondly, various aspects related to the nature of the general standards will be discussed as background material to understanding the standards and their implementation. Included are an explanation of how and by what institutions the standards are defined and interpreted, an analysis of the interrelationships of the general standards to each other and to the standards of field work and reporting, and a description of the major environmental factors influencing the standards.

The following three chapters constitute the heart of the study, concentrating on the individual standards and guidelines for adherence to them. The guidelines consist of the meaning of the standards, indications of adherence to them, and the means by which the auditor can evaluate his own adherence to the standards.

The internal organization of the chapters is described by the following outline.

- Development of generally accepted auditing standards to 1947
- The general standards of auditing
  - Definition and interpretation
  - Interrelationships and underlying concepts
  - Environmental aspects
- Independence
  - Meaning
  - Conditions adverse to independence
  - Indicators of independence
  - Evaluating independence
- Technical training and proficiency
  - Meaning
  - Indicators of adequate technical training and proficiency
  - Evaluation of technical training and proficiency
- Due care
  - Meaning
  - Indicators of due care

Evaluating due care
Summary and conclusions

Contribution This Dissertation Makes

The primary contribution of the dissertation is attainment of its stated objective: a better understanding than now exists of adherence to the general standards of auditing through development of guidelines for such adherence. Auditors, teachers and students of auditing, the general public, auditing clients, shareholders, creditors, and others relying on audited financial statements or otherwise interested in the auditor's work, as a result of the study, have access to a clearer meaning of adherence to the general standards. While the dissertation is not expected to be the final word on adherence to the standards, it should contribute to their initial clarification and expansion in meaning. Later discussion and criticism of the guidelines developed here as well as further development of guidelines will be necessary for a continuing interpretation of adherence to the general standards. Other contributions include ideas for further research suggested by that involved in the dissertation and a bibliography of informative sources related to auditing standards.

CHAPTER II

DEVELOPMENT OF GENERALLY ACCEPTED AUDITING STANDARDS TO 1947

Introduction

The first formal statement of generally accepted auditing standards appeared in the Tentative Statement of Auditing Standards published by the American Institute of Accountants in 1947. The statement contained nine standards with the tenth being added in 1954. These standards fall into three groups as follows:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the

determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.[1]

The standards were issued as a direct result of the Securities and Exchange Commission's requiring auditors to state in their reports "whether the audit was made in accordance with generally accepted auditing standards

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[1]American Institute of Certified Public Accountants, Committee on Auditing Procedure, Statement on Auditing Standards: Codification of Auditing Standards and Procedures (New York: American Institute of Certified Public Accountants, Inc., 1973), p. 5.

applicable in the circumstances."[2] The result of this requirement was much discussion at meetings and in articles to establish the standards which, as Carman Blough pointed out, "have long been inherent in the writings of authorities on the subject and basic in the practice of public accounting."[3] This chapter presents evidence supporting Blough's statement that auditing standards did exist in the public accounting profession before they were formally stated. The evidence, introduced chronologically, includes early writings and textbooks on auditing, charters of various accounting associations, discussions of ethics and standards, court cases, and official pronouncements of accounting organizations. While all standards are covered by the discussion, the focus of attention is the set of personal or general standards.

Development and Evidence of Auditing Standards Before 1947

Events Before 1900

Of the ten generally accepted auditing standards, the three classed as general, or personal, standards were in evidence from the beginning of the accounting profession. These three--training and proficiency, independence,

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[2]U. S., Securities and Exchange Commission, Accounting Series Releases, Series 1 to 77, Release No. 21 (1956), p. 39.

[3]Carman G. Blough, "Auditing Standards and Procedures," The Accounting Review 24 (July 1949): 265.

and due care--existed before the formation of professional accounting associations. Edward Wilcox in discussing professions requiring highly skilled and specialized services, a group into which accounting clearly falls, stated

> Whenever such professional services are rendered, some standards of quality are present. This is true today, and it was equally true ten or fifty or a hundred years ago. . . . These standards were not always written or printed or even acknowledged by name; they may have been high or low, adequate or inadequate, but they existed. They were the standards of skill, integrity and care of the professional practitioners.[4]

While all three general standards are necessary for a highly qualified and professional auditor, they were not recognized at the same time.

> Historically independence was the first requirement; the need for that was recognized even before the need for technical competence; it was the climate into which the profession was born.[5]

The concept of independence was inherent in the profession of public accounting from the time of its origin--"whenever the advance of civilisation brought about the necessity of one man being entrusted to some extent with the property of another . . . ."[6] It was maintained and demonstrated initially through systems of checks by separate records

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[4]Edward B. Wilcox, "Professional Standards," in CPA Handbook, ed. by Robert L. Kane, Jr., 2 vols. (New York: American Institute of Accountants, 1956), 2, ch. 13:1.

[5]American Institute of Accountants, Executive Committee, "Independence of the Certified Public Accountant," The Journal of Accountancy 84 (July 1947): 51.

[6]Richard Brown, History of Accounting and Accountants (London: Frank Cass and Company Limited, 1905), p. 74.

with audits to ascertain agreement between records.[7] Later, in the nineteenth century, acts were passed forbidding auditors to be interested in their clients' concerns.[8]

Competence began as a standard in ancient times, encompassing basic skills such as reading, writing, arithmetic, and elementary bookkeeping. Further development of the standard came with publications such as Paciolo's mathematical treatise which explained bookkeeping and with establishment of professional accounting associations.[9] In England and America, charters of the accounting associations outlined the knowledge and education required of accountants.[10]

Due care was established as a standard through court cases recognizing auditors as professionals. In 1833, the following statement of an auditor's duty was made.

> Every man who offers his services to another and is employed, assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the

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[7]Ibid., pp. 21, 24, 74-80.

[8]Lawrence R. Dicksee, Auditing--A Practical Manual for Auditors (London: Gee & Company (Publishers) Limited, 1895), pp. 379-85.

[9]Brown, History of Accounting and Accountants, pp. 20, 120-33, 177-78.

[10]See Brown, History of Accounting and Accountants, p. 207; and James Don Edwards, History of Public Accounting in the United States (East Lansing, Michigan: Michigan State University, 1960), pp. 25, 51, 55, 65, 78.

> public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession.[11]

In 1895, limits on the duty were placed in the case, In re London and General Bank (No. 2).

> An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly shew the true position of company's affairs; he does not even guarantee that his balance-sheet is accurate according to the books of the company. If he did he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part, say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this. . . . What is reasonable care in any particular case must depend on the circumstances of that case.[12]

The level of skill required in exercising due care was defined in 1896 as "that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use."[13] Two other cases of the period established that an auditor "is not excused because he knows nothing about auditing or the requirements of the statute under which he is appointed," and that an auditor "cannot argue for a lower standard of care because the assistant assigned by

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[11]Thomas M. Cooley, A Treatise on the Law of Torts or the Wrongs Which Arise Independently of Contract, students' ed. by John Lewis (Chicago: Callaghan & Company, 1907), pp. 668-69.

[12]R. W. V. Dickerson, Accountants and the Law of Negligence (Toronto: The Canadian Institute of Chartered Accountants, 1966), p. 13.

[13]Ibid., p. 14.

him to the audit work is not fully qualified, or because the audit was done for a low fee."[14]

The three general standards of auditing existed before the beginning of the twentieth century. Although initially developed outside the United States, they became a part of this country's professional auditing requirements with the influx of English accountants in the late nineteenth and early twentieth centuries. The remainder of the chapter concentrates on their development in the United States.

Events in the United States from 1900 to 1929

After 1900 in the United States, the general standards were expressed in more detail and the standards of field work and reporting made their appearances through efforts by professional societies and in articles, textbooks, and official pronouncements.

Efforts of professional societies notably were directed to development of the competence standard and resulted in provision of university courses in accounting and establishment of accounting departments.[15]

Articles of the period covered all three standards. Early examples include a series of articles resulting from

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[14]Ibid., p. 18.

[15]See Sydney G. Winter, "What Is Proper Training for Accountants?" The Accounting Review 16 (June 1941): 183; and Edwards, History of Public Accounting in the United States, pp. 78-79.

an invitation by the editor of The Public Accountant to leading practitioners to contribute their definitions of a public accountant. These definitions clearly recognized competence and independence as important personal qualities.[16] In 1905, Robert H. Montgomery called for the establishing of high professional standards to which all public accountants should be held,[17] and at the 1907 annual meeting of the American Association of Public Accountants, standards were suggested. Those standards discussed brought out in the papers presented included training, independence, due care, and supervision.[18]

Major textbooks in auditing at this time were Dicksee's Auditing edited by Montgomery for American publication and Montgomery's own Auditing Theory and Practice published in 1913. Both included the general standards. Competence appeared in descriptions of the auditor and the knowledge he should have. For example, in Dicksee's book

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[16]Norman E. Webster, "What Is a Public Accountant?" The New York Certified Public Accountant 14 (November 1944): 705-708, quoting The Public Accountant during the period January to June, 1900.

[17]Robert H. Montgomery, "Professional Standards: A Plea for Co-operation Among Accountants," The Journal of Accountancy 1 (November 1905): 28-39.

[18]See Franklin Allen, "Professional Ethics," The Journal of Accountancy 5 (December 1907): 97-99; John Alexander Cooper, "Professional Ethics," The Journal of Accountancy 5 (December 1907): 81-94; R. H. Montgomery, "Professional Ethics," The Journal of Accountancy 5 (December 1907): 94-96; and J. E. Sterrett, "Professional Ethics," The Journal of Accountancy 4 (October 1907): 407-31.

auditors were described as having "special training," being "competent and responsible," and as possessing "a large staff of specially trained assistants."[19] Montgomery outlined competence as including knowledge of bookkeeping and accounting, extensive preliminary education, general experience, special faculties such as imagination, knowledge of law, and moral qualities.[20] Independence was assumed by Montgomery,[21] and it was indicated in Dicksee's book in citations from acts prohibiting the auditor's being a director in the client company, calling for appointment by and reporting to shareholders, and stressing the need for the auditor's access to records.[22] Due care was defined through leading English cases, no American precedents having been set. Two field work standards, internal control and evidence, also were presented, and the reporting standard of disclosure appeared.[23]

Official pronouncements began with the 1917 Uniform Accounting prepared by the American Institute of

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[19]Lawrence R. Dicksee, Auditing: A Practical Manual for Auditors, ed. Robert H. Montgomery (New York: The Ronald Press Company, 1909), p. 269.

[20]Robert H. Montgomery, Auditing Theory and Practice (New York: The Ronald Press Company, 1913), pp. 24-30.

[21]Ibid., p. 19.

[22]Dicksee, Auditing: A Practical Manual for Auditors, pp. 286-88.

[23]See Dicksee, Auditing: A Practical Manual for Auditors, pp. 56, 174; and Montgomery, Auditing Theory and and Practice, pp. 17, 80, 83, 573.

Accountants and accepted and published by the Federal Reserve Board. While consisting for the most part of audit procedures, "it was an attempt to set a standard for the profession" by standardizing balance-sheet audits.[24] Standards stated or implied in it included independence, evidence, disclosure, internal control, expression of an opinion, and conformance to principles of accounting.[25] In 1929, this document was revised and issued as Verification of Financial Statements, but no new or additional standards were included.[26]

By the end of 1929, then, the accounting profession in the United States had auditing standards either stated or implied in its professional code of ethics, official pronouncements, articles, and textbooks. These standards included general, field work, and some reporting standards--consistency and reference to generally accepted principles of accounting yet to be clearly formulated and officially stated.

Major Events Leading to Formal Adoption of Standards--1930 to 1939

The major events leading to the formal adoption of standards began in the 1930's. During that time, standards

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[24]"Uniform Accounting," The Journal of Accountancy 23 (June 1917): 401.

[25]Ibid., pp. 401-30.

[26]American Institute of Accountants, "Verification of Financial Statements," The Journal of Accountancy 47 (May 1929): 321-54.

were much in evidence in court cases, correspondence between the American Institute of Accountants and the New York Stock Exchange, Securities Acts, cases brought before the Securities and Exchange Commission, and in publications of the American Institute of Accountants.

Litigation

The standard of due care in auditing had been given expression by English courts in cases involving legal responsibility of accountants. However, up to this time American auditors "had not had their responsibility clearly interpreted," assuming instead that English cases would serve as precedents.[27] The Ultramares case decided in 1931 provided an American interpretation of accountants' legal responsibility and an American precedent for future cases. In his decision, Judge Cardozo stated auditors were to be held liable to third parties for fraud but not mere negligence, and he defined the scope of fraud.

> The defendants owed to their employer a duty imposed by law to make their certificate without fraud, and a duty growing out of contract to make it with the care and caution proper to their calling. Fraud includes the pretense of knowledge when knowledge there is none. To creditors and investors to whom the employer exhibited the certificate, the defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself. . . . A different question develops when we ask whether they owed a duty to these to make it without negligence.

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[27] J. R. Taylor, "Some Antecedents of the Securities and Exchange Commission," The Accounting Review 16 (June 1941): 189.

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.
> . . . .
> . . . if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract is made.[28]

Judge Cardozo's decision was upheld in the 1937 case of O'Connor v. Ludlam and the 1938 case of State Street Trust Co. v. Ernst.[29]

Correspondence Between the American Institute of Accountants and New York Stock Exchange

From 1932 to 1934 correspondence between the American Institute of Accountants and the New York Stock Exchange gave consideration to generally accepted accounting principles and proper auditing procedures. The principles of accounting and auditing discussed were broad in scope--a move away from listing detailed procedures and techniques characteristic of the 1917 and 1929 pamphlets and a move toward recognizing the professional aspects of auditing in which judgment plays a major role.

The correspondence, published in 1934 as Audits of Corporate Accounts, concentrated many of the standards already in existence and brought out those not previously

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[28]Leon Green, et al., Cases on the Law of Torts (St. Paul, Minnesota: West Publishing Co., 1968), pp. 999, 1004.

[29]Saul Levy, Accountants' Legal Responsibility (New York: American Institute of Accountants, 1954), pp. 34-44.

clearly formulated. Independence and competence were assumed since the New York Stock Exchange required "independent public accountants, qualified under the laws of some state or country" for certificates in listing applications.[30] Internal control was brought out in discussions of auditors' responsibilities, and its importance and effect on audits were explained.[31] Evidence, while not given particular emphasis in the correspondence, was implied in reference to the scope of audits--to be "not less than that indicated in . . . 'Verification of Financial Statements'"--and in the suggested short form report which stated the auditors had "examined or tested accounting records of the Company and other supporting evidence and obtained information and explanations from officers and employees of the Company . . . ."[32] The idea of generally accepted accounting principles made its appearance in the correspondence through indications of principles which had won general acceptance, and the suggested short form report referred to the financial statements as being "in accordance with accepted principles of accounting."[33]

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[30]American Institute of Accountants, Special Committee on Co-operation with Stock Exchanges and New York Stock Exchange, Committee on Stock List, <u>Audits of Corporate Accounts</u> (New York: American Institute of Accountants, 1934), p. 14.

[31]Ibid., pp. 19, 23-24, 26.

[32]Ibid., pp. 18, 30.

[33]Ibid., pp. 10, 17-18, 31.

Consistency in the application of accounting principles by corporations was called for, and reference to it became a part of the short-form report.[34] Disclosure of accounting methods employed was encouraged and considered along with consistency in their application and with regard to the form financial statements should take. Specific items to be disclosed in the balance sheet and income statement were given, and the general basis of accounts was suggested for disclosure.[35] The fourth reporting standard calling for an expression of opinion in the auditor's report was strengthened by the New York Stock Exchange's requiring the inclusion of an auditor's certificate in listing applications from corporations and by the American Institute of Accountants' stressing the desirability of including in the audit report the phrase "in our opinion" to accent the fact auditors' statements can only be expressions of opinion. The short form report accordingly included that phrase.[36]

With the publication of this correspondence, the ten generally accepted auditing standards had found their way into the profession of accounting and had been given official sanction by the American Institute of Accountants.

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[34] Ibid., p. 31.

[35] Ibid., pp. 11-14.

[36] Ibid., pp. 14, 28, 31.

<u>Securities Acts</u>

The passage of the Securities Act of 1933 and the Securities Exchange Act of 1934 mainly affected three auditing standards. These were independence, adequate disclosure, and generally accepted accounting principles. In cases heard before the Securities and Exchange Commission, the standard of due care also was examined, but the effects of those cases will be discussed separately.

Independence was an established standard in auditing before the formation of the SEC, but, according to Phillip Defliese,

> the SEC deserves most of the credit for accelerating the development of the independence concept. In its regulations and decisions--both formal and informal--the SEC has been particularly insistent that accountants who certify statements for filing with it be independent.[37]

In Regulation S-X, the principle accounting regulation of the SEC, the Commission stated it would not recognize a public accountant as independent if he were not in fact independent, and it described the situations in which an accountant would not be considered independent.[38] Further, the Commission stated it would consider "all relevant

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[37]Phillip L. Defliese, "The Influence of SEC on Accounting Principles and Procedures and the Practice of Auditing," <u>Accounting Papers of the Twelfth Annual Conference of Accountants</u> (Tulsa: The University of Tulsa, April 23 and 24, 1958), p. 70.

[38]U. S., Securities and Exchange Commission, "Regulation S-X," <u>Form and Content of Financial Statements</u> (1947), p. 3.

circumstances including evidence bearing on all relationships between the accountant and that registrant" in deciding whether an accountant would not be independent.[39] In its Accounting Series Releases, the SEC has enumerated specific instances where independence has been found lacking.[40]

The standard of adequate disclosure was directly influenced by the Securities Act of 1933, often referred to as a disclosure statute, since it specifies the information to be furnished prospective buyers of securities. It also requires companies selling securities and listed on national exchanges to file annual reports which become available to the public.[41] In administering the Securities Acts and thereby upholding the standard of adequate disclosure, the SEC has stressed full and fair disclosure of of facts needed by the investor.[42]

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[39] Ibid.

[40] See Rappaport, SEC Accounting Practice and Procedure, 3d ed. (New York: Ronald Press Company, 1972), ch. 26; and U. S., Securities and Exchange Commission, Accounting Series Releases--Compilation of Releases 1 to 112 Inclusive, Releases Nos. 47, 81, 112 (1968), pp. 60-64, 196-203, 297-98; U. S., Securities and Exchange Commission, Standing Audit Committees Composed of Outside Directors, Accounting Series Releases, No. 123 (1972); and U. S., Securities and Exchange Commission, Independence of Accountants--Guidelines and Examples of Situations Involving the Independence of Accountants, Accounting Series Releases, No. 126 (1972).

[41] Defliese, "The Influence of SEC on Accounting Principles and Procedures and the Practice of Auditing," p. 66.

[42] Ibid., p. 73.

Generally accepted accounting principles are affected indirectly by Securities Acts through authorization given the Commission to prescribe the principles to be followed in financial statements filed with it. Although the SEC has set forth requirements as to the form and content of financial statements and has stated its opinions on some accounting principles, it has "for the most part been content to rely on generally accepted principles of accounting as they exist, or develop with the passage of time."[43]

Official Pronouncements

While independence had been assumed a necessary qualification of auditors in the pronouncements of the American Institute of Accountants and had been provided for and described in regulations administered by the SEC, no specific rules were adopted by the American Institute of Accountants to cover its ethical implications until 1936. In that year, the following resolution was adopted.

> RESOLVED. That no member or associate shall certify the financial statements of any enterprise financed in whole or in part by the public distribution of securities if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest.[44]

This resolution remained the Institute's official statement concerning independence until 1941.

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[43]Ibid., p. 66.

[44]Casler, The Evolution of CPA Ethics: A Profile of Professionalization (East Lansing, Michigan: Michigan State University, 1964), p. 13.

In 1936, the American Institute of Accountants revised its 1917 and 1929 publications in the form of Examination of Financial Statements by Independent Public Accountants, reiterating those standards expressed in Audits of Corporate Accounts but adding little to their explanation. Two phrases later to become a part of the formally stated auditing standards were used in the publication. These were "generally accepted accounting principles" and "adequate disclosure."[45]

Cases Before the Securities and Exchange Commission

In the McKesson and Robbins case, the Securities and Exchange Commission had among its purposes determining "whether the audit by the accountants conformed to generally accepted standards" and "whether the existing generally accepted auditing standards were adequate to assure the reliability of financial statements."[46] On termination of hearings, the SEC presented a summary of its findings and conclusions in Accounting Series Release No. 19. These findings and conclusions added to the meaning of several of the auditing standards. Independence of the auditors had been found lacking, and certain conditions which the SEC felt would bolster it were listed. Included were

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[45]American Institute of Accountants, Examination of Financial Statements by Independent Public Accountants (New York: American Institute of Accountants, 1936), pp. 1, 10.

[46]Defliese, "The Influence of SEC on Accounting Principles and Procedures and the Practice of Auditing," p. 67.

election of auditors by stockholders; use of audit committees; addressing audit certificates to stockholders; attendance at stockholders' meetings; where the auditor does not complete an engagement, his rendering a report on the work done and reasons for noncompletion; and full recognition by auditors of their responsibility to the public.[47] The SEC suggested more attention to the training of staff, expanding the planning function to cover investigation of new and unknown clients as a suitable background for interpreting conditions revealed in the audit; more emphasis on internal control; stressing the obtaining of sufficient competent evidence to support an opinion, particularly with regard to confirmation of accounts receivable and observation of inventory taking; and verification measures for other accounts.[48] In discussing independent verification, the SEC stated

> The time has long passed, if it ever existed, when the basis of an audit was restricted to the material appearing in the books and records. For many years accountants have in regularly applied procedures gone outside the records to establish the actual existence of assets and liabilities by physical inspection or independent confirmation. As pointed out repeatedly in this report, there are many ways in which this can be extended.[49]

Improvements in reporting involved making a clear statement of whether the audit was adequate for expressing an

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[47]U. S., Securities and Exchange Commission, <u>Accounting Series Releases</u>, Release No. 18 (1956), pp. 29-30.

[48]Ibid., pp. 30-35.

[49]Ibid., p. 35.

opinion, naming any generally accepted procedures omitted and reasons for omission, and clearly designating exceptions to the scope of the audit.[50] The finding of a lack of due care exercised in the case prompted the following comment.

> In carrying out the work they failed to employ that degree of vigilance, inquisitiveness, and analysis of the evidence available that is necessary in a professional undertaking and is recommended in all well-known and authoritative works on auditing.[51]

The case evoked much discussion on what constituted standard auditing procedures and prompted publication by the American Institute of Accountants of Extensions of Auditing Procedure containing fundamental auditing principles and extended procedures believed to be necessary as a part of generally accepted practice.[52] These "certain fundamentals" of auditing in the statement closely approached the idea of auditing standards and included the following:

> In the performance of his duties as auditor the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure.
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> . . . .
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> . . . he has become not only skilled in accounting and auditing but has acquired the ability and habit of considering dispassionately and independently the facts recorded in books of account . . . .
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> . . . .
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> It is the duty of the independent auditor to satisfy

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[50]Ibid., p. 33.

[51]Ibid., p. 34.

[52]Defliese, "The Influence of SEC on Accounting Principles and Procedures and the Practice of Auditing," p. 58.

> himself that the system of internal check and control is adequate and sufficiently effective to justify reliance thereon.
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> . . . .
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> In the judgment of this committee the independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, and that they conform to generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and if appropriate his reasons for omitting an expression of opinion.[53]

Besides the above fundamentals, worded in similar manner to the generally accepted auditing standards, others implied the standard of evidence and means of acquiring it. As in the findings of the SEC, confirmation of accounts receivable and verification of inventories were emphasized.[54]

The Interstate Hosiery Mills, Inc. case also occurred in 1939 and was concerned with the issue of whether the auditing firm "had exercised due care in reviewing the work of its staff member."[55] The SEC concluded ordinary procedures for review of subordinates' work needed thorough revision "to insure the integration of the original work papers with the financial statements" and "to analyze in a

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[53]American Institute of Accountants, "Extensions of Auditing Procedure," The Journal of Accountancy (June 1939): 342-44.

[54]Ibid.

[55]Ibid., p. 69.

searching manner the ultimate facts developed in the course of the actual audit."[56]

The decade of the 1930's thus included events having great influence on the development of standards, but the factors directly influencing the formal statement of auditing standards appeared early in the following decade.

Formal Adoption of Auditing Standards

In 1941, as a result of the McKesson and Robbins case, the SEC required auditors to state in their reports "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances."[57] The wording required by the SEC meant the Commission felt the auditor would make a direct representation to the fact he conformed to the standards. The American Institute of Accountants felt an auditor should state only in his opinion he had conformed to them because a recognized statement of generally accepted auditing standards did not exist, but it later concluded the Commission's stance was reasonable and the profession could take an important step by developing such a statement.[58]

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[56]Ibid.

[57]U. S., Securities and Exchange Commission, Accounting Series Releases, Release No. 21 (1956), p. 39.

[58]Paul Grady, "Auditing Standards," The New York Certified Public Accountant 16 (December 1946): 675.

The Committee on Auditing Procedure of the American Institute of Accountants "requested the assistance of practicing certified public accountants throughout the country and coöperation of state accounting societies" in defining the standards.[59] To begin the discussion of standards and to solicit ideas from others on them, Samuel J. Broad, then chairman of the Committee on Auditing Procedure, presented a paper at the 1941 meeting of the American Institute of Accountants in which he listed twenty-six standards.[60] Many of his standards were, in essence, procedures, but the paper brought out relevant concepts which were to become generally accepted auditing standards. These concepts were due care, evidence, internal control, generally accepted accounting principles, independence, and consistency.[61] His paper was discussed at meetings of state societies, in criticisms sent to the Committee on Auditing Procedure, and in accounting articles. Two such articles criticized Broad for dwelling on procedures and brought attention to additional standards. Henry Hawes stated he did not see any reasons for an approved statement of auditing standards and that the SEC's statement

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[59]S. S. Webster, Jr., "Why We Need Auditing Standards," The Journal of Accountancy 75 (May 1943): 429.

[60]Ibid., pp. 429-30.

[61]Samuel J. Broad, "Auditing Standards," The Journal of Accountancy 12 (November 1941): 390-97.

with regard to standards covered only competence.[62] In elaborating on competence, however, he listed characteristics of some of the standards later adopted:

> The standards of competency are education, training, independence, ability, and character, and not a body of rules as to how professional men are to use their competency to carry out a given task.[63]

S. S. Webster, in another article on standards, also felt Broad had stated procedures rather than standards, but instead of denying the need for such a statement "condensed, summarized, and supplemented" Broad's list by omitting much of the detail.[64]

After having been required by the SEC since 1941 to refer to generally accepted auditing standards in the short form report and after having suggested standards discussed and criticized by members of the profession, the Committee on Auditing Procedure of the American Institute of Accountants issued the Tentative Statement of Auditing Standards in 1947 for possible adoption by the members. The nine standards proposed were adopted in 1948.

> With considerable accuracy, therefore, it can be said that our generally accepted auditing standards appeared as the direct result of pressure by the S.E.C. for improvement in the form and content of accountants' short form reports. But accurate as this claim may be, it is little more than a half truth. It can be contended with equal validity that by the late

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[62] Henry C. Hawes, "Auditing Standards," The Journal of Accountancy 74 (August 1942): 111-12.

[63] Ibid., p. 111.

[64] Webster, "Why We Need Auditing Standards," p. 430.

1930's, public accountants as a group were becoming aware of the professional nature and stature of their work to an extent never before so generally felt.

. . . .

The profession was ripe for such efforts as development of professional standards. The McKesson-Robbins Case and the S.E.C. may have forced the issue a few years earlier than would otherwise have been the case, but the pressure was certainly mounting. The explosion of interest in principles, standards, and professional responsibilities which even the second world war could not stem was inevitable and would not have delayed much longer even without the timely urging of the S.E.C.

. . . .

The profession was ready for the development of auditing standards, true, but nevertheless it did wait until urged by the S.E.C. before making any real progress.[65]

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[65]R. K. Mautz, "A Critical Look at Generally Accepted Auditing Standards," Proceedings of the Twentieth Annual Institute on Accounting (Columbus, Ohio: Ohio State University Publications, May 15 and 16, 1958), pp. 16, 17, 24.

CHAPTER III

THE GENERAL STANDARDS OF AUDITING

Introduction

The general standards of auditing are defined or interpreted by various institutions, interrelated, necessary to the proper implementation of field work and reporting standards, and applied in an environment which in turn affects their application. These characteristics of the general standards give a broad idea of their nature and of the factors influencing adherence to them.

Definition and Interpretation of the General Standards of Auditing

The *Tentative Statement of Auditing Standards* identified the general standards of auditing but did not provide specific definitions or a means of interpreting adherence to the standards in particular instances. Rather, definitions and interpretations have been provided by institutions such as the public accounting profession which includes individuals as well as societies, the legal profession, and the Securities and Exchange Commission.

The Accounting Profession

The profession consists of many elements including national, state, and local societies; accounting firms;

practitioners; professors; students. Therefore, definitions from this source range in degree of authoritativeness and application to actual auditing engagements.

Of the professional auditing societies, the American Institute of Certified Public Accountants is the most authoritative and has the widest influence on interpreting the standards. To generally publicize its definitions and interpretations, it incorporates them in its official publications and its code of ethics, and they are discussed in accounting periodicals such as The Journal of Accountancy, at professional meetings, and in continuing education and professional development programs. The main approach is solving current problems of adherence to the standards encountered in the practice of auditing, the aims being to promote and maintain high professional standards by focusing the collective experience and ability of the profession on current problems.[1] Referring to particular standards, competence includes thorough and continuing knowledge and understanding of the definitions and interpretations as well as how to implement them in practice. Independence includes avoidance of certain relationships and activities proscribed by the Institute, and it has been interpreted for specific situations. Due care includes application of auditing procedures recognized as necessary

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[1]Walter B. Meigs, E. John Larsen, and Robert F. Meigs, Principles of Auditing (Homewood, Illinois: Richard D. Irwin, Inc., 1973), pp. 10-11.

for properly carrying out field work and reporting. In addition, competence and due care encompass definitions and interpretations of accounting principles and other criteria used in judging financial statements.

Accounting firms define and interpret the general standards of auditing through firm policies. Competence of auditors beyond that acquired by formal education includes initial training programs, supervised experience in audit assignments, and efforts for continuing education. Continuing education, itself, is enhanced through opportunities for further formal education, adequate libraries, and means of informing auditors of new developments. Independence is interpreted by firm policies prohibiting relationships or activities which could impair it. Such policies may involve proper procedures for an auditor not independent of a particular client, restrictions on various relationships between auditors and clients, holding auditors responsible for their work, and supporting auditors who exert independence. Due care is defined and interpreted through the existence and enforcement of policies concerning audit procedures and techniques applied to field work and reporting functions.

Individual members of the profession interpret the general standards through such means as research, writing, speeches, audits, and professional development. Research, writing, and speeches, for example, may be directed at either specific problems in the practical application of standards or to broader interpretations. Support for these efforts may come through accounting organizations providing funds, publishing writings, and holding regular professional meetings for discussions. In performing audits, individuals interpret the practical application of auditing standards. Since auditing standards would serve no real purpose if not applicable to audits, the working or practical interpretations given by individual auditors are important.

The Legal Profession

Definitions and interpretations of auditing standards by the legal profession are found in statutes and results of court cases, and they may differ from those of the auditing profession. Areas of law in which the interpretations appear are statutory, contract, and tort law.

Statutory Law

Statutory laws--those created by legislative action--exist at federal and state levels and usually are administered by an agency established for the purpose. The most important of these laws are federal securities acts administered by the Securities and Exchange Commission. These acts, the Securities Act of 1933 and the Securities Exchange Act of 1934, empower the SEC to prescribe detailed auditing procedures.[2] Although this power has not been

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[2]Louis H. Rappaport, SEC Accounting Practice and Procedure, 3d ed. (New York: Ronald Press Company, 1972), p. 5.1.

exercised by the SEC, its potential use acts as a stimulus to the auditing profession to maintain adequate procedures for adherence to auditing standards. Its definitions and interpretations of the general standards of auditing are found in Regulation S-X, the principal accounting regulation of the SEC, and in the securities acts. The standard of competence finds interpretation in the description of a competent auditor defined as one who is "in good standing as such under the laws of the place of his residence or principal office."[3] Independence is interpreted through descriptions of circumstances under which an auditor is considered lacking in independence and of conditions relevant to a decision regarding the existence of independence in particular cases.[4] Due care is interpreted through description of the criteria for fair presentation and adequate disclosure against which the auditor must judge financial statements. Fair presentation is described in Regulation S-X which sets forth requirements regarding the form and content of financial statements for fair presentation.[5] Adequate disclosure is covered by the Securities Act of 1933 which requires the filing of specific financial information.[6] Due care also is interpreted through the

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[3]Ibid., p. 26.18.

[4]Ibid.

[5]Ibid., chs. 16-20.

[6]Ibid., p. 1.3.

liabilities an auditor has under the securities acts. These liabilities are more fully discussed in the due care chapter. At the state level, statutory laws, in an indirect and limited way, interpret the standard of competency through barring from the practice of public accounting persons not properly qualified or through limiting practice to members of a qualified group.[7]

Contract and Tort Law

The areas of contract and tort law are considered together, the distinction between the two lying in the origin of the duty of care:

> In tort the duty is independent of any agreement of the parties and is imposed upon them by the law. In contract the duty to take care arises from the agreement made by the parties.[8]

In contract and tort law, definitions and interpretations of the general standards appear in results of litigation containing opinions of judges as well as testimony of expert witnesses as to what they believe constitutes adherence to the standards.

One interpretation of the standards, as emphasized in the recent Pacific Acceptance case, is they should be

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[7]The Commission on Standards of Education and Experience for Certified Public Accountants, Standards of Education and Experience for Certified Public Accountants (Michigan: Bureau of Business Research, University of Michigan, 1956), p. 27.

[8]R. W. V. Dickerson, Accountants and the Law of Negligence (Toronto: The Canadian Institute of Chartered Accountants, 1966), p. 3.

implemented in light of changed conditions. While the standards remain the same, they are directed toward changed circumstances.

> It is not a question of the Court requiring higher standards because the profession has adopted higher standards. It is a question of the court applying the law which by its content expects such reasonable standards as will meet the circumstances of today, including modern conditions of business and knowledge concerning them.[9]

An important characteristic of legal interpretations of standards is they may differ from those of the accounting profession. In the Continental Vending case, for example, the jury was allowed to evaluate the public accountants' work according to its own judgment and to convict the auditor

> . . . even if it found that such work conformed in all respects to the recognized standards of their profession. So far as diligent research discloses, this is the first case, criminal or civil, to hold that conduct governed by professional standards may be measured otherwise than by those standards.[10]

With regard to adequate disclosure, the court in this case essentially said

> that the determination of what is material or what is adequate disclosure will be made by the court <u>applying standards developed by the cases</u>, which are not necessarily the same as the standards developed by the accounting profession.[11]

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[9]Robert W. V. Dickerson, "Pacific Acceptance Corporation Limited v. Forsyth et al.," <u>Canadian Chartered Accountant</u> 100 (April 1972): 73.

[10]American Institute of Certified Public Accountants, "AICPA Brief in Continental Vending," <u>The Journal of Accountancy</u> 129 (May 1970): 71.

[11]Donald Stuart Bab, "Current Thoughts About the Legal

In rendering interpretations different from those of the accounting profession, the law attempts to uphold the standards in substance, looking behind the auditors' actions to determine whether they acted in good faith. Such an attempt was made in Continental Vending. The standards represent the minimum which should be done, and the law recognizes the minimum may be insufficient.

> Compliance with generally accepted standards may be evidence 'persuasive but not necessarily conclusive' that good faith was employed.
> The courts will go behind the whole conduct of the parties.[12]

Different interpretations also are rendered when procedures established by the profession to carry out the standards are found to be inadequate. The Pacific Acceptance case is an example of this type of interpretation. Although an English case, it does have implications for American auditors. In discussing it, Gordon Samuels pointed out that, in general, if an auditor acts according to the profession's accepted standards and procedures, he will likely go unscathed, but he will not necessarily have a defense if the established practices are inadequate.[13] In that case, Judge Moffitt said:

Liability of the CPA," The New York Certified Public Accountant 41 (June 1971): 442.

[12]A. Beedle, "Lessons from the Continental Vending Case," Canadian Chartered Accountant 98 (May 1971): 354.

[13]Gordon Samuels, "Protecting Your Practice Against Liability," The Chartered Accountant of Australia 41 (August 1971): 8.

> When conduct of an auditor is in question in legal proceedings it is not the province of the auditing profession itself to determine what is the legal duty of auditors or to determine what reasonable skill and care requires to be done in a particular case, although what others do or what is usually done is relevant to the question of whether there had been a breach of duty.[14]

An American case in which established procedures for implementing standards were found inadequate is 1136 Tenants' Corporation vs. Max Rothenberg & Company. While the case involved unaudited financial statements, it does demonstrate the law might prescribe procedures different from those of the accounting profession. In this case, the court found need for a certain amount of auditing procedures in write-up work despite the fact the AICPA maintained the certified public accountant has no responsibility to apply auditing procedures to unaudited financial statements.[15] The fact legal interpretations at times differ from those of the accounting profession is important to and must be considered by auditors because they are held legally responsible for them.

In addition to defining and interpreting the general auditing standards, the law has established them. Most notably, the standard of due care was established in the legal area of negligence. One element of negligence is the failure to exercise due care, and, in the case of

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[14]Ibid.

[15]Emanuel Saxe, "Unaudited Financial Statements: Rules, Risks and Recommendations," The CPA Journal 42 (June 1972): 461.

professionals, the law has established the measure of due care as being the exercise of skill and competence commonly possessed by others in the same field.[16] Furthermore, that skill and competence must be of the quality possessed by a prudent, reasonably competent practitioner--a definition based on the legal concept of a reasonable man.[17] By establishing due care and defining it in terms of skill and competence, the law also has established a competence standard at the level of skill possessed by the average practitioner, not at that of the most or least competent practitioner. Common law has not established the independence standard in the same way it has competence and due care, and independence usually is not a legal issue unless it affects the auditor's professional judgment in applying another auditing standard such as adequate disclosure.[18]

The influence of contract and tort law on interpretations of the general standards of auditing is felt through court cases involving accountants, and that influence is important in setting legal precedents against which auditors are held liable in implementing auditing

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[16]Wiley Daniel Rich, Legal Responsibilities and Rights of Public Accountants (New York: American Institute Publishing Co., Inc., 1935), pp. 4, 6.

[17]R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (Menasha, Wisconsin: George Banta Company, Inc. for the American Accounting Association, 1961), p. 132.

[18]Thomas W. Hill, Jr., "The Public Accountants' Legal Liability to Clients and Others," The New York Certified Public Accountant 38 (January 1968): 27.

standards. Since the law will not accept a defense of conformance to inadequate procedures or conformance to standards in form only, the accounting profession has, at times, had to alter its interpretations to conform to the legal ones when its own have been proved inadequate.

The Securities and Exchange Commission

The Securities and Exchange Commission, as discussed in the previous chapter, provided the initial impetus for the formal statement and adoption of auditing standards. Since then, the SEC has defined and interpreted them through administration of securities acts and regulations, cases heard before it, and publication of its *Accounting Series Releases*.

Although the SEC generally does not exercise its power to prescribe auditing procedures essential for adherence to the standards, relying instead on the accounting profession to take the initiative, it does criticize auditing practices and procedures if inadequate and, in the area of independence, specifically states what it considers to be impairments.[19] In criticizing inadequate auditing procedures and practices, the SEC has interpreted the general standards of competence and due care. Competence has been interpreted by bringing out elements composing it. For example, in the McKesson and

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[19]Rappaport, *SEC Accounting Practice and Procedure*, pp. 5.1, 26.20-55.

Robbins case the partner in charge of the audit was found to be "not sufficiently familiar with the business practices of the industry in question" and "not sufficiently concerned with the basic problems of internal check and control to make the searching review which an engagement requires."[20] The partner, then, did not employ those procedures necessary to become familiar with the business and its internal control functions and was, therefore, incompetent with regard to the audit. Due care similarly has been interpreted in cases of inadequate examinations through emphasis on necessary auditing procedures found to be lacking. In the McKesson and Robbins case, necessary auditing procedures determined to be inadequate or not employed at all related to the scope of the audit, staff training, investigations of clients, review of internal control, verification of accounts, and issuance of the auditor's certificate.[21] By determining the procedures necessary for an adequate examination, the SEC provides a current interpretation of the due care standard.

The SEC enforces its decisions through administering rules of practice under which it has power to institute disciplinary proceedings against accountants to disqualify

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[20]U. S., Securities and Exchange Commission, Accounting Series Releases--Compilation of Releases 1 to 112 Inclusive, Release No. 19 (1968), p. 22.

[21]Ibid., pp. 29-34.

and deny them the right to practice before it.[22] These disciplinary proceedings not only apply with regard to competence and due care but also to situations in which auditors lack independence.[23] In this regard, the SEC has had a great impact on the standard by defining it in terms of certain impairments leading to presumption of a lack of independence.

> The SEC emphasizes the specific relationships between an accountant and his client which give rise to a presumption of lack of independence, that is, the SEC will not recognize an accountant as independent if any of the proscribed relationships exist.[24]

Rulings by the SEC proscribing relationships indicating a lack of independence have involved conscious falsification of facts, financial interests in the client, connections with the clients in managerial capacities, original work on accounting records under audit, relationships with clients' employees, contingent fees, subordination of judgment to clients' desires, incompatible occupations, and outside business relationships with clients.[25]

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[22]Rappaport, SEC Accounting Practice and Procedure, p. 27.19.

[23]Ibid., p. 26.24.

[24]Philip L. Defliese, "The Influence of SEC on Accounting Principles and Procedures and the Practice of Auditing," Accounting Papers of the Twelfth Annual Conference of Accountants (Tulsa: The University of Tulsa; April 23 and 24, 1958), p. 70.

[25]Rappaport, SEC Accounting Practice and Procedure, pp. 26.27-55.

The SEC's approach to defining and interpreting auditing standards is similar to that of the legal profession in that it expresses its ideas through cases pointing out reasons the standards were not met or specific procedures necessary for meeting them. Like legal cases under contract and tort law, the SEC brings into consideration changing conditions and may interpret standards differently from the accounting profession.

Summary of the Definition and Interpretation of the General Standards of Auditing

The general standards of auditing were initially identified and broadly defined by the American Institute of Accountants. They have been interpreted and further defined by the accounting profession, the legal profession, and the Securities and Exchange Commission. The interpretations change with changing conditions in society, the economy, and business and have varying degrees of influence on the practice of auditing depending on their source. Usually, they take the form of a description of qualities making up the standard. For example, competence usually is defined by describing what the auditor should know and the extent of training and experience he should have; independence, by describing impairments to it; due care, by describing practices and procedures required for field work and reporting.

Interrelationships and Concepts Underlying Adherence to the General Standards

The nature of the general standards is such that they

> . . . to a great extent are interrelated and interdependent. Moreover, the circumstances which are germane to a determination of whether one standard is met may apply equally to another.[26]

They are interrelated with each other and with the standards of field work and reporting. Circumstances germane to the determination of whether standards are met include accounting, auditing and legal concepts applied to auditing work.

Interrelationships

All three of the general standards of auditing must be present for a public accountant to be considered a professional man and for the audit opinion to be unbiased. Without the other two, any one of the three would be rendered useless. For example, the auditor's opinion on financial statements is desired because he has the competence to audit statements and determine whether they are fairly presented. He thus adds credibility to the financial statements. Credibility, though, also depends on his being independent.

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[26]American Institute of Certified Public Accountants, Committee on Auditing Procedure, Statement on Auditing Standards: Codification of Auditing Standards and Procedures (New York: American Institute of Certified Public Accountants, Inc., 1973), p. 6.

> For no matter how competent any CPA may be, his opinion on financial statements will be of little value to those who rely on him--whether they be clients or any of his unseen audience of credit grantors, investors, governmental agencies and the like--unless he maintains his independence.[27]

The application of technical training and proficiency to an audit is useless if the results of that application are unacceptable, and independence makes the results acceptable.

> As we consider the connotations of the phrase "he should be his own master", the indispensable relationship of competence with independence becomes apparent. Apart from the more general senses of having authority or having a business of one's own and managing one's own affairs, allowing no interference from others; a master is a person possessing some special aptitude, art, accomplishment, or quality of mind to a pre-eminent degree; with the implication of intellectual control and mastery--having one's emotions and passions and actions under the control of one's reason--and knowing one's subject thoroughly.
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> . . . .
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> Each professional man must find his own competence and with it win his independence.[28]

In addition to the support each gives the other, the exercise of competence indicates independence.

> Whether an individual is independent or not depends largely on whether he exercises his professional judgment, influenced by the intellectual content of his profession and whether the principal consideration in exercising such judgment is the public good.[29]

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[27]American Institute of Certified Public Accountants, Code of Professional Ethics (New York: American Institute of Certified Public Accountants, Inc., 1972), p. 8.

[28]John L. Rawnsley, "The Ethical Basis of the Profession," The Chartered Accountant in Australia 39 (July 1968): 26, 29.

[29]Hill, "The Public Accountants' Legal Liability to Clients and Others," p. 27.

Due care and competence are interrelated in that exercise of the auditor's technical training and proficiency define the duty of care.

> Every man who offers his services to another and is employed, assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence.[30]

Furthermore, due care is the measure of competence employed in the audit.

> The independent, trained and proficient accountant knows what to do and how to do it; care is the degree of application of this knowledge.[31]

Independence and due care are interrelated in the sense that without independence, the auditor's work--no matter how skillfully executed--is unacceptable to those relying on his opinion. As with competence, without independence, the opinion lacks credibility.

> The question of what constitutes an adequate examination tends to merge with the question of independence. If the accountant lacks independence, it is a simple matter for him to cut corners in his examination.[32]

In summary, the general standards are interrelated in the sense all three are necessary simultaneously, each supporting or requiring the others.

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[30] Rich, Legal Responsibilities and Rights of Public Accountants, p. 6.

[31] Edward B. Wilcox, "Professional Standards," in CPA Handbook, ed. Robert L. Kane, Jr., 2 vols. (New York: American Institute of Accountants, 1956), 2, ch. 13: 11.

[32] Rappaport, SEC Accounting Practice and Procedure, p. 26.24.

> To begin with, all that is said about observing certain standards in the employment of auditing procedures naturally concerns such procedures as they are employed by properly trained and experienced auditors. . . . Granted that the auditor is thus technically proficient, the next test he must undergo is that of independence . . . since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. But it is not enough for the auditor to be technically proficient and independent as well; he may be both of these, as to the undertaking at hand, and yet be guilty of lack of due care in the performance of his work--a dereliction which may even be judged the graver when chargeable against one of high qualification otherwise.[33]

The general, field work, and reporting standards are interrelated in two senses. From the standpoint of general standards, the other seven indicate areas with which they are concerned and outline the direction of their implementation. From the standpoint of field work and reporting standards, general standards "concern the indispensable conditions for the satisfactory attainment of such other standards."[34] General standards "are of such a pervasive nature that when one, or more, of them is not met the remaining seven standards are not really relevant."[35]

Competence, for example, includes expert knowledge of the subject matters involved in the standards of field

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[33]E. A. Kracke, "Auditing Standards: The Personal Standards of the Auditor," The New York Certified Public Accountant 16 (December 1946): 677.

[34]Ibid.

[35]D. R. Carmichael and J. V. Bencivenga, "Lack of Independence--Some Reporting Problems," The Journal of Accountancy 134 (August 1972): 80.

work and reporting. That is, competence covers audit planning and supervision, elements of internal control and its evaluation, gathering and evaluation of evidence, generally accepted accounting principles, determination of consistency in the application of accounting principles, determination of the adequacy of disclosures made, and the ability to render an opinion concerning the fairness of the client's financial statements. Besides knowledge of these areas, competence includes experience and training necessary for forming judgments required by each standard.

Independence is essential to the standards of field work and reporting.

> If the auditor is not independent he cannot perform an audit in accordance with generally accepted auditing standards. The auditor's inability is unequivocal, for the auditing standards are not mutually exclusive. Further, the nature of the general standards is such that they permeate the standards of field work and reporting. It follows that when the auditor is not independent, no aspect of his examination can be in accordance with generally accepted auditing standards. Under these circumstances, the auditor is precluded from expressing an opinion on financial statements.[36]

Furthermore, independence is required for the exercise of "judgment and objective consideration of facts as the determinants of the opinion."[37] In turn, adherence to the field work and reporting standards provides a test or

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[36]Joseph Bencivenga and D. R. Carmichael, "Reporting on Lack of Independence," The Journal of Accountancy 129 (March 1970): 68.

[37]John A. Lindquist, "Auditing Standards: Standards

display of independence in that an auditor lacking it would not carry out these standards in substance. For example, independence is indicated by the auditor's insisting the standard of adequate disclosure be met.

> Perhaps the most critical test of the actuality of an accountant's independence is the strength of his insistence upon full disclosure of transactions between the company and members of its management as individuals; accession to the wishes of the management in such cases must inevitably raise a serious question as to whether the accountant is in fact independent.[38]

The interrelationship between due care and the standards of field work and reporting is described in the following statement.

> Due care imposes a responsibility upon each person within an independent auditor's organization to observe the standards of field work and reporting.[39]

In adhering to these standards, the auditor by definition adheres to the due care standard.

> Briefly stated, then, these further standards . . . outline the general procedural tests as to whether or not the auditor's work has been performed with due care; not merely whether proper procedures have been employed, but beyond that whether, under all circumstances of a case, those procedures have been properly applied and coordinated.[40]

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of Reporting," The New York Certified Public Accountant 16 (December 1946): 690.

[38]U. S., Securities and Exchange Commission, Accounting Series Releases--Compilation of Releases 1 to 112 Inclusive, Release No. 37 (1968), p. 52.

[39]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 10.

[40]Kracke, "Auditing Standards: The Personal Standards of the Auditor," p. 682.

Adherence to the field work and reporting standards, then, indicates due care in audit examinations and reporting, but the reverse also is true. The field work and reporting standards assume due care will be exercised in their employment. Due care is required for an adequate audit examination without which "the independent certified public accountant lacks the fundamentals for formulating, let alone, expressing an opinion."[41]

Auditing standards are interrelated to the extent that no one standard can be upheld without also carrying out the others.

> Independence, competence, and due care, it can well be reiterated in summary, all are fundamental standards to be ever borne in mind by the independent certified public accountant in the planning and execution of an examination, and the reporting thereon.[42]

The above quote may be paraphrased to state the field work and reporting standards are to be borne in mind in adhering to independence, competence, and due care.

Concepts Underlying Adherence to the Standards

Circumstances germane to meeting the standards take the form of conditions or concepts underlying adherence to them. Conditions include assumptions the auditor is a professional person, performs his duties as would a prudent practitioner, and has ethical and legal

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[41]Lindquist, "Auditing Standards: Standards of Reporting," p. 691.

[42]Ibid., p. 693.

responsibilities along with corresponding liabilities. Concepts underlying the standards include materiality and relative risk, time and cost, and the mental state of doubt versus belief.

Professionalism

Public accountants consider themselves professionals engaged in the profession of public accountancy and, as such, must meet the requirements of a profession which include the following:

1. A body of specialized knowledge,
2. A recognized formal educational process for acquiring the requisite specialized knowledge,
3. A standard of professional qualifications governing admission to the profession,
4. A standard of conduct governing the relationships of the practitioner with clients, colleagues, and the public,
5. Recognition of status,
6. An acceptance of the social responsibility inherent in an occupation endowed with public interest,
7. An organization devoted to the advancement of the social obligation of the group.[43]

Competence involves "training adequate to meet the requirements of a professional man"[44] which covers the first three characteristics and ensures the fifth. Specialized knowledge is proficiency "in accounting and auditing," attainment of which "begins with the auditor's formal education and extends into his subsequent

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[43]The Commission on Standards of Education and Experience for Certified Public Accountants, Standards of Education and Experience for Certified Public Accountants, p. 1.

[44]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 7.

experience."[45] Admission to the profession of accounting and particularly designation as a certified public accountant require formal education, experience, and the passing of a written examination. Because the specialized knowledge and skills are not held by members of society in general and are at a professional level, the public accountant is accorded a recognized status.

Independence assumes the fourth and sixth characteristics and is necessary for attaining the fifth. The auditor's code of ethics specifically covers relationships with clients, colleagues, and the public, and it holds him to the standards of independence, integrity, and objectivity with regard to clients.[46] Independence becomes a requirement because the auditor has a social responsibility endowed with public interest. Were he only responsible to clients, independence would not be important as it does not benefit the client's interest. He is given a recognized status through ability to render an independent opinion on the client's representations.

Due care, like independence, assumes the fourth and sixth characteristics and assures the fifth. The auditor's standard of conduct with regard to his relationships with clients and the public means he performs his work with the due care and skill of a professional man. By

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[45] Ibid.

[46] American Institute of Certified Public Accountants, Code of Professional Ethics, pp. 20-22.

accepting responsibility to the public, his work and reporting must be carried out with due care to avoid corresponding liabilities. Through the standard of due care, which assumes a professional standard of conduct and acceptance of social responsibility, the auditor is assured a recognized status. In turn, this status assumes due care has been exercised in the audit.

> . . . The certified public accountant, by virtue of his attained position and contract of employment, must exercise the care and competence reasonably expected of persons in his profession to ascertain the facts on which his financial report is made.[47]

The seventh characteristic of an organization devoted to the advancement of the social obligations of the group is met by the existence of the American Institute of Certified Public Accountants. This characteristic affects all the general standards because it is through the AICPA that they mainly are promulgated and enforced.

Since auditors are considered professionals, their personal standards encompass the characteristics of professionals, and, in turn, the characteristics necessitate adherence to the standards.

Prudent Practitioner

The professional auditor, in satisfying the requirements of the general standards, is judged by what a prudent

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[47] Dickerson, Accountants and the Law of Negligence, p. 2, quoting from the case: Stanley L. Bloch, Inc. v. Klein 258 NYS 2d 501 (1965) at page 506.

practitioner--a concept related to that of the reasonable man--would do. Mautz and Sharaf have developed a partial concept of the prudent practitioner based on the legal concept of the prudent man, including the following requirements:

> The prudent man is:
>
> (1) Required to exercise judgment equal to that of the level of his community. . . . He must exercise as sound judgment as would another possessed of the same extent of information available to him at the time.
>
> (2) Required to use with reasonable intelligence the knowledge which he has. . . . If he acts within a given sphere or comes into relationships with people or things which would give a reasonably intelligent person specialized knowledge or experience, he is presumed to have such knowledge. . . . the prudent man is expected to keep up with his community both in general and specialized knowledge.
>
> . . . .
>
> (3) Assumed to possess and exercise reasonable skill in his ordinary and occupational activities. In this respect he is required to exercise the degree of skill possessed by the general class of people engaged in that activity or line of work.
>
> . . . .
>
> (4) Required to recognize and give due consideration to his experience.[48]

The legal concept of a prudent man and its extension into a concept of the prudent auditing practitioner are apparent in the general standards. Competence assumes all of the above requirements from basic intelligence to specialized knowledge and experience. The prudent practitioner "must measure up to the standard of competence of the ordinary practitioner," not the most or least skillful.[49] Relationships proscribed to maintain independence

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[48]Mautz and Sharaf, The Philosophy of Auditing, pp. 132-39.

[49]Dickerson, Accountants and the Law of Negligence, p. 2.

in appearance are based on the perceptions of reasonable men.

> In establishing rules relating to independence, the profession uses the criterion of whether reasonable men, having knowledge of all the facts and taking into consideration normal strength of character and normal behavior under the circumstances, would conclude that a specified relationship between a CPA and a client poses an unacceptable threat to the CPA's integrity or objectivity.[50]

Due care assumes a prudent practitioner nct only possesses but exercises his knowledge and skill. The exercise of knowledge and expertise must be made with a reasonable degree of care and skill, referring to that level the ordinary or average practitioner would employ.[51]

The concept of a prudent practitioner is not precisely defined. It depends, to a great extent, on litigation and continually changes to meet new developments.[52] Nevertheless, the auditor is judged by such a concept, and his standards must conform to it.

Responsibilities and Liabilities

The auditor, as a professional man, bears responsibility for his audit opinions and the work on which they are based. His responsibilities can be ethical or legal, the two not necessarily being the same. They apply to

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[50]American Institute of Certified Public Accountants, Code of Professional Ethics, p. 9.

[51]Ibid.

[52]Mautz and Sharaf, The Philosophy of Auditing, p. 135.

relations with clients, colleagues, and the public or third parties. Where conflict exists among the various groups, the auditor must weigh results of alternative actions available to him in deciding which should be given priority, but, in general, responsibilities to the public take precedence. Legal liabilities may arise if the auditor fails to meet his responsibilities. The general standards of auditing recognize the auditor's responsibilities, and acting in accordance with them means those responsibilities will be met, limited by the fact that different interpretations of the standards may be given by the legal and accounting professions.

Competence recognized the auditor is responsible for

> . . . possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public opinion.[53]

From the above statement, failure to meet the responsibility of possessing the required competence--essentially the same as pretending to have knowledge which is nonexistent--results in liability to the extent of fraud. Since the public specifically relies on the auditor's work, he has the responsibility to it of employing the proper degree of competence. In relations with clients, the auditor has

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[53]Rich, <u>Legal Responsibilities and Rights of Public Accountants</u>, p. 6.

responsibility to "serve his clients with competence and with professional concern for their best interests."[54] In relations with colleagues his responsibilities include "support of a profession by its members and their cooperation with one another."[55] Support of the profession further involves calling in fellow practitioners if the auditor lacks highly specialized knowledge necessary for carrying out the work[56] and compliance with auditing standards of which competence is one.[57]

Independence is based on the concept of responsibilities, particularly in regard to relations the auditor has with the public. Thomas W. Hill has described the standard's dependence on this concept.

> If, however, the primary thrust of the work in which the public accountant is engaged, so far as it involves the expression of opinions on financial statements, is directed at third parties, then independence becomes the keystone of the responsibility to be assumed.
>
> Independence becomes important because the interested party, the stockholder or creditor or the like, has no way to evaluate objectively the work performed by the public accountant and the recommendations, if any, made by him, except as the work performed is reflected in his opinion.
>
> It will be an independent opinion only if the public accountant issuing it affirmatively recognizes

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[54]American Institute of Certified Public Accountants, Code of Professional Ethics, p. 12.

[55]Ibid., p. 13.

[56]Ibid., p. 14.

[57]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 4.

> the identity of those to whom he is actually rendering services, namely, the public.[58]

To the auditor's clients, however, his independence is not an important consideration in his carrying out his responsibilities to them.

> Independence is not something that greatly concerns the client since he is in a position to evaluate objectively the views expressed by the public accountant on questions which interest him.[59]

Referring to relationships with colleagues, maintenance of independence is a means of supporting the profession and its standards.

Of the three general standards, due care is probably most directly related to the area of responsibilities and liability. In relationships with clients and third parties, the auditor is responsible for performing his work with due care, and if he does not meet this responsibility he is considered negligent and legally liable to those injured. Negligence in the narrow, legal sense of the word refers to the "non-performance or the inadequate performance of a legal duty," and it is based on failure to exercise due care, breach of duty, injury, and defendant's act being the proximate cause of injury.[60] As is discussed under due care, the law, in judging due care or

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[58]Hill, "The Public Accountants' Legal Liability to Clients and Others," p. 29.

[59]Ibid.

[60]Rich, Legal Responsibilities and Rights of Public Accountants, p. 4.

negligence of auditors, relies to a great extent on what is done by other professional auditors or what is considered good professional practice. That is, the law considers the auditor's professional duties as indicators of due care or its absence. Negligence in a broader sense could be considered as encompassing moral as well as professional and legal duties, but legal liability does not follow from failure to exercise a moral duty. The classic example is that of one man observing another in the act of drowning. Morally, the observer should attempt to save the one drowning, but legally he is not bound to make such an attempt. While negligence can be described according to degree,

> The better and more recent view of negligence holds that "the law imposes but one duty in such cases, and that is the duty to use due care; and the law recognizes only one standard by which the quantum of care can be measured, and that is the care which a person of ordinary prudence would exercise under like circumstances."[61]

Although the auditor has been held liable to clients for simple negligence and to third parties for gross negligence, that view is not always accepted as was shown in the Hedley Byrne case in which third parties did not have to show gross negligence.[62] In any case, if the auditor

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[61] Ibid., p. 5.

[62] Hill, "The Public Accountants' Legal Liability to Clients and Others," pp. 23-24.

adheres to the standard of due care he fulfills his responsibilities to both clients and third parties, thus avoiding legal liability. In relationships with colleagues, the auditor must exercise due care in supporting the profession through respecting its standards.

Adherence to the general standards of auditing is necessary for the auditor to meet his ethical and legal responsibilities to clients, third parties, and colleagues. In the case of legal responsibilities, meeting them avoids legal liability to clients and third parties. While competence and independence are essential to meeting responsibilities and avoiding liabilities, due care is the standard most directly associated with these concepts.

Materiality and Relative Risk

Materiality and relative risk are concepts used in making auditing judgments which are part of adhering to the general standards. Materiality is defined as follows:

> Materiality, as used in accounting, may be described as a state of relative importance. The materiality of an item may depend on its size, its nature, or a combination of both. An item should be regarded as material if there is reason to believe that knowledge of it would influence the decisions of an informed investor.[63]

Relative risk refers to the probability that an account may be subject to substantial error or

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[63] American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Madison, Wisconsin: School of Commerce, University of Wisconsin, 1957), p. 8.

misstatement or that an audit may involve misstatement, fraud, or violation of accounting principles.[64] That is, relative risk is the susceptibility of an item to error. The two concepts are considered together because they overlap.

> Here we encounter a mutuality in terms which defies separate consideration. For present purposes it is doubtful if materiality has any practicable meaning apart from risk, and relative risk is a mere academic concept when not accompanied by materiality.
>
> It follows that materiality and relative risk are primary factors not only as to the engagement as a whole but also as to the various assets, liabilities and other items which are to be substantiated.[65]

Competence assumes ability to judge the materiality and relative risk of various items in an audit, implying accounting knowledge, training, and experience behind such judgments. It includes specific knowledge of the client under audit because the materiality and relative risk of items are not the same for all.

Independence assumes the auditor is not biased through overlooking, either accidentally or purposefully, material items or items relatively more susceptible to error. Consideration of all material items and items of relative risk also indicates independence has been maintained whereas failure to consider them would indicate its

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[64] Meigs, Larsen, and Meigs, Principles of Auditing, p. 220.

[65] Alvin R. Jennings, "Auditing Standards: Standards for Field Work," The New York Certified Public Accountant 16 (December 1946): 684.

lack. Materiality enters into independence in another sense since it is used in deciding the types of relationships prohibited in maintaining it.

> While it may be difficult for a CPA always to appear completely independent even in normal relationships with clients, pressures upon his integrity or objectivity are offset by powerful countervailing forces and restraints.
>
> . . . .
>
> Accordingly, in deciding which types of relationships should be specifically prohibited, both the magnitude of the threat posed by a relationship and the force of countervailing pressures have to be weighed.[66]

Materiality and relative risk are important to due care in field work and reporting. In field work, the auditor emphasizes obtaining evidence for material items and those most likely to be misstated or in error.

> The concept of materiality is inherent in the work of the independent auditor. There should be stronger grounds to sustain the independent auditor's opinion with respect to those items which are relatively more important and with respect to those in which the possibilities of material error are greater than with respect to those of lesser importance or those in which the possibility of material error is remote.
>
> . . . .
>
> The degree of risk involved also has an important bearing on the nature of the examination.[67]

Relative risk has the same bearing on the gathering of evidence as does materiality in that it affects the amount and quality of evidence required for particular items.

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[66]American Institute of Certified Public Accountants, Code of Professional Ethics, p. 9.

[67]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 6.

> When relative risk is above normal, the auditor should demand more and better evidence than he would normally require as a basis for his opinion.
>
> . . . .
>
> The concept of relative risk may also be applied to the gathering of evidence on particular items in the financial statements.[68]

In reporting the audit results and rendering an opinion, the auditor is concerned with materiality in connection with the criteria against which fairness of financial statements are measured. If statements "depart materially from generally accepted accounting principles," for example, the auditor cannot render an unqualified opinion.[69] Likewise, if disclosures of material matters are inadequate, the auditor cannot give an unqualified opinion.

The auditor, then, must be competent enough to form judgments making use of the materiality and relative risk concepts, must be independent to act on those judgments, and must exercise due care in using the competence he has.

Time and Cost

The concepts of time and cost refer to the length of time available for performing the audit and the cost involved in acquiring information or evidence. Time and cost do not govern the extent of audit work, but, as ultimately limited resources, they are important

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[68]Meigs, Larsen, and Meigs, Principles of Auditing, p. 220.

[69]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 110.

considerations. Were they not limited, judgments and opinions would not be necessary.

> If cost and time were not factors, every physical thing asserted in the financial statements could be examined to give certainty of their existence to the auditor.
> . . . .
> But cost and time are important; it would be unreasonable to incur substantial costs to ascertain the existence of assets of inconsequential amounts. It might also be unreasonable to incur substantial costs to prove the existence of assets of even significant amounts if other types of evidence are sufficiently persuasive and more readily available.[70]

Competence covers ability through accounting knowledge and auditing experience to make judgments concerning time and cost. Examples of these judgments include initially determining the feasibility of the audit in a given amount of time, the necessary sequence in time of various auditing procedures, and the amount of time for various audit activities. Cost considerations might include determining the cost to acquire additional evidence, the total cost to undertake the engagement, and the most economically efficient means of auditing.

In terms of independence, time and cost decisions may reflect the existence of nonexistence of bias or pressures. For example, pressures may exist in the form of the client's urging the auditor to rush through an examination or to cut corners to reduce its cost. In addition, lack of independence may be indicated by giving too little time to important elements or too much time to

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[70]Mautz and Sharaf, The Philosophy of Auditing, p. 85.

relatively unimportant ones. Likewise, performing an audit for inadequate fees could indicate a lack of independence.

The standard of due care recognizes time and cost decision aspects of field work and reporting. Planning an audit involves considerations such as the time needed for carrying out all phases of the audit, the need for simultaneous or surprise examinations, and cut-off dates. The study of internal control and the gathering of evidence involve considerations of the time and cost to acquire information and come to an evaluation of the degree of reliance to be placed on them. Reporting decisions related to time include timely issuance of the report and the time period over which the auditor is responsible for disclosing information to the public.

To summarize, time and cost considerations are a part of each of the general standards of auditing, but they do not govern the extent of audit tests to be carried out in the examination. In substance, they are limited resources requiring dependency on judgments and opinions as opposed to reliance on complete examinations of every item in the statements.

Doubt Versus Belief

Doubt and belief are concepts basic to auditing standards as is indicated in the following statement:

> The auditor frequently is directed to satisfy himself by inquiry about such specific financial statement assertions as asset balances, revenues, and expenses.

> The key phrase here is "satisfy himself," which implies belief.[71]

Belief has been described as "a matter of mental assent,"[72] and it has been contrasted with the mental state of doubt.

> Doubt is an uneasy and dissatisfied state from which we struggle to free ourselves and pass into the state of belief; while the latter is a calm and satisfactory state which we do not wish to avoid, or to change to a belief in anything else. On the contrary, we cling tenaciously, not merely to believing, but to believing just what we do believe.
>
> Thus, both doubt and belief have positive effects upon us, though very different ones. Belief does not make us act at once, but puts us into such a condition that we shall behave in some certain way, when the occasion arises. Doubt has not the least such active effect, but stimulates us to inquiry until it is destroyed.
>
> . . . .
>
> The irritation of doubt causes a struggle to attain a state of belief. I shall term this struggle <u>Inquiry</u>. . . .[73]

This description emphasizes that belief is more than a feeling of assurance or certitude[74]; it is a conclusion having a reasoned basis of support, that basis being inquiry to the extent the auditor is convinced. Absolute certainty, while desirable, cannot be the only acceptable

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[71] American Accounting Association, Committee on Basic Auditing Concepts, "Report of the Committee on Basic Auditing Concepts," <u>The Accounting Review</u> 47 (Supplement 1972): 37-38.

[72] Ibid., p. 38.

[73] Charles S. Pierce, "The Fixation of Belief," <u>Essays in the Philosophy of Science</u>, ed. Vincent Thomas (New York: The Liberal Arts Press, Inc., 1957), pp. 11-12.

[74] John Dewey, <u>The Quest for Certainty: A Study of the Relation of Knowledge and Action</u> (New York: G. P. Putnam's Sons, 1929), pp. 227-28.

state of belief. Lesser degrees of certainty, based on evidence ranging from persuasive to conclusive, are not only acceptable but necessary since the auditor cannot have all the knowledge and evidence required for complete certainty. Could such knowledge and evidence be acquired, the auditor's judgment and opinion, particularly in the area of value judgments, would not be useful or relevant. Users of financial statements could rely on absolute facts rather than professional judgment.

> . . . although the auditor may have reasonable assurance of the adequacy of his program, he seldom, if ever, can obtain absolute certainty. Except in elemental situations where a complete examination of all details is required and undertaken, it would appear that the auditor would be guilty of contemplating more work than could be justified if he seeks to plan his engagement so that he may be absolutely sure it will meet the tests of due care.
>
> If he cannot secure certainty, he can, by prejudging the implications of due care, at least obtain a satisfactory and workable degree of confidence.[75]

Relating the concepts of belief and doubt to the general standards, competence assumes the auditor has sufficient training and experience to, first, know when to doubt and, second, how to satisfy himself concerning those doubts. As Mautz and Sharaf have pointed out, a novice may easily be misled into believing anything he is told because he has not been taught or has not learned to doubt whereas "A seasoned practitioner with adequate training and a variety of experience is much more difficult to

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[75]Jennings, "Auditing Standards: Standards for Field Work," p. 683.

convince."[76] This statement does not mean the competent auditor should be difficult to convince at all times. It does mean he realizes the difference between feelings of certitude or assurance or belief and reasoned conclusions leading to belief. In removing doubt, the competent auditor must know what evidence he needs and be able to judge it.

Maintenance of an independent state of mind requires the auditor to be able to form his own judgments. Forming independent judgments in turn means the auditor is able to remove doubt from his mind and satisfy himself concerning the fairness or unfairness of presentations made in the published financial statements.

Due care in field work and reporting includes steps to remove doubt and establish belief.

> The prudent practitioner will take all appropriate steps to remove from his own mind any doubtful impressions or unanswered questions concerning matters material to his opinion.[77]

In this area, the standard of evidence particularly relates to the removing of doubt and the establishing of belief. Reporting standards include the expression of an opinion regarding the financial statements under audit, and an "opinion" implies belief, being defined as "a

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[76]Mautz and Sharaf, The Philosophy of Auditing, p. 90.

[77]Ibid., p. 136.

belief stronger than impression and less strong than positive knowledge."[78]

Summary of Concepts Underlying Adherence to the General Standards of Auditing

Circumstances germane to meeting the general standards are diverse in most senses, but all have a bearing on the nature of the standards. They are assumptions on which adherence to the standards is based and in general provide a background for guidelines for adherence to the standards. These assumptions include professionalism, the concept of the prudent practitioner, responsibilities and liabilities of a professional, the concepts of materiality and relative risk, considerations of time and cost, and the mental state of belief versus that of doubt.

Aspects of the Auditor's Environment

Like accounting, auditing responds to the needs of the environment rather than initially creating those needs, and adherence to auditing standards thus is affected or shaped by the environment in which auditing is practiced. Aspects brought out here are not intended as a detailed or all-inclusive description of the environment but, instead, as a general description of its aspects which bear directly on auditing. The environment in which auditing standards are applied is essentially the business world, but that

[78] *Webster's Third New International Dictionary*, s. v. "opinion."

area and auditing are affected by peripheral areas including society in general, the government, education, and law. These areas will be covered first with attention focused on their major characteristics and effects on auditing.

Society in General

All aspects of the environment discussed here are part of the general society, but they do not cover everything affecting auditing. For that reason, aspects not so covered are here singled out.

Social priorities are an important aspect of the society bearing on the nature of the general standards because business activities and auditing must be consistent with them. Galbraith has described the relationship between the goals of society and business, and this relationship can be extended to auditing.

> The relationship between society at large and an organization must be consistent with the relation of the organization to the individual.
>
> . . . .
>
> More specifically, the goals of the mature corporation will be a reflection of the goals of the members of the technostructure. And the goals of the society will tend to be those of the corporation.
>
> . . . .
>
> None of this is to suggest that all social attitudes originate with the technostructure and its needs. Society also has goals, stemming from the needs which are unassociated with its major productive mechanism, and which it imposes on the mature corporation. As elsewhere I argue only for a two-way process. The mature corporation imposes social attitudes as it also responds to social attitudes.[79]

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[79]John Kenneth Galbraith, The New Industrial State, 2d ed. (Boston: Houghton Mifflin Company, 1971), pp. 159, 161, 165.

Extending the relationship to auditing standards, they must conform to the goals and needs of society. As discussed in the legal section under definitions of standards, interpretations of the standards change with changing circumstances in the economy and business. For example, competence now includes computer knowledge as a reflection of changing technology; independence involves questions of management services, an aspect of public accounting coming into greater focus; due care depends on field work and reporting standards reflecting new methods and changing accounting criteria. When auditing standards do not conform to social goals and priorities, new standards or interpretations are imposed from outside the profession by, for example, the courts or the Securities and Exchange Commission. Seidler has pointed out cases which have imposed on auditing the recognition of society's goals.

> . . . the more critical lesson in many of the recent cases may lie in the indication that the verdicts show that society is indeed changing its concepts of what it expects to get from CPAs.
>
> Consider the court's 1968 holding in the Continental Vending case (U. S. v. Simon), particularly as compared to McKesson & Robbins in 1939. In both cases the defense position was that the auditors had at least conformed to the minimal standards of their profession. In 1939, the court was willing to accept minimal conformity with the standards developed by the profession as adequate to satisfy public policy. But by 1968 the atmosphere had changed. The courts were no longer willing to accept the standards established by the profession; instead the state (in the person of the court) was quite willing to substitute its own standard.

> Consider, too, the <u>1136 Tenants' Corporation</u> case. . . . Here, the profession's usual explanation of its own work category . . . was rejected. Instead, the court held the accountant (who was not engaged as an auditor) to some of the standards of an auditor, essentially on the grounds that the public expected him to be an auditor.[80]

Seidler further points out that society's demands must be met if the accounting profession is to retain its monopoly in accounting and auditing matters. As he notes, much criticism has been levelled at the profession for various deficiencies, and society not only will demand change but, because it possesses greater power, will force change.[81] To determine whether its goals are being met by particular institutions, society can call for an accounting of the information it needs. Being a service function, accounting changes to accommodate the needs for new information, and auditing standards change to the necessary degree for auditing such accounting results. As an illustration of society's power, the Securities and Exchange Commission recently has ordered more meaningful disclosure concerning companies' compliance with environmental protection laws.[82] Since auditors now must judge whether such disclosures are adequate and whether compliance actually has occurred, auditing standards are changed to include this social goal.

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[80]Lee J. Seidler, "Accountant: Account for Thyself," <u>The Journal of Accountancy</u> 135 (June 1973): 40-41.

[81]Ibid., p. 41.

[82]"SEC Orders Disclosure of Impact of Ecology Rules," <u>The Journal of Accountancy</u> 135 (June 1973): 22.

Government

The most outstanding characteristic of government is its large size with corresponding power and pervasiveness into all areas of society. The form of government is democratic with support for private ownership of business and primary interest in public and consumer protection. Its effects on auditing standards mainly come about in two ways--through its support of the corporate system of business and through its laws, regulations, and agencies.

Government support of the corporate system appears in the form of supplementing the planning activities of corporations--activities which are of great importance and which are described in the section below dealing with the business environment. In supporting these activities, the government regulates stability of prices through wage and price controls; manages total consumer demand through taxes, public expenditures, and monetary policy; supplies specialized manpower through publicly supported education; and underwrites advanced scientific and technical developments such as atomic power, antimissile defenses, weapons systems, and supersonic air transports. That is, "Wherever the private corporation cannot plan, the state comes in and performs the required function."[83] This support by the government of the corporate system is so pervasive

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[83] John Kenneth Galbraith, "Market Planning and the Role of Government," The Atlantic 219 (May 1967): 69-79.

that Galbraith has predicted the two institutions eventually will be viewed as part of the same complex:

> Given the deep dependence of the industrial system on the state and the nature of its motivational relationship to the state, i.e., its identification with public goals and the adaptation of these to its needs, the industrial system will not long be regarded as something apart from government. Rather it will increasingly be seen as part of a much larger complex which embraces both the industrial system and the state.[84]

Since the bulk of accounting and auditing is carried out in relation to corporations, auditing is involved with these corporate and governmental activities. Accounting reports reflect the consequences of corporate activity supported by the government, and auditing of those reports likewise considers them. As governments and corporations become closely associated, corporate activities, including accounting, will become more closely tied to governmental goals or policies, and they will be shaped by the type of educational and technological support provided by the government. Auditors must include in their standard of competence an awareness of this association and its ramifications. As the two move closer together, independence is subjected to different impairments and pressures. For example, the auditor could face the possibility of rejecting an accounting practice because fairness or adequate disclosure is lacking even though the accounting practices employed are supported or desired by two strong factions.

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[84]Galbraith, The New Industrial State, p. 395.

Need for corporate autonomy, if backed by government, could become a very strong force in pressuring the auditor to render unqualified opinions or put management's interests above that of third parties. The standard of due care faces changes in interpretation because of different kinds and levels of skill used to measure it and because of changes in the elements of field work and reporting.

The effect of government's laws, regulations, and agencies on the auditing profession were covered in part in the discussions concerning statutory laws and the Securities and Exchange Commission. Other effects on auditing come, for example, through industry regulations and tax laws because the auditor must determine the client's compliance with them. These laws, regulations, and agencies affect all the standards to some extent but are particularly important to competence and due care in field work. Competence necessarily includes knowledge of the various regulations and laws if the auditor is to judge compliance with them. Due care in field work covers gathering and evaluation of evidence pertinent to such compliance.

In summary, government support of the industrial and corporate systems means accounting and auditing must be concerned with and reflect their activities. Since the auditor's clients must comply with government laws and regulations, the auditor must have knowledge of and test compliance with them. For audits of governmental organizations, programs, activities, and functions, a compliance standard is suggested,[85] but for audits of financial statements, such testing of compliance is an aspect of the evidence standard.

Education

Education is characterized as including rapidly expanding knowledge; as being geared to a high level of technology; as reflecting corporate, in particular technological, needs; and as being supported by the government.[86] The auditor, being a prudent man, "is expected to keep up with his community both in general and in specialized knowledge."[87] Therefore, his competence must include education at the level of the average member of society as well as of the average practitioner in good professional standing. Since auditing education, which satisfies a large part of the competence standard, is shaped by the education of society in general, it also must reflect rapid changes in the level of education and technology and can be said to be geared to corporate and technological needs. As emphasis is placed on the general level and quality of education held by society's members, it also

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[85]U. S., Comptroller General, Standards for Audit of Governmental Organizations, Programs, Activities & Functions (1972), p. 28.

[86]Galbraith, The New Industrial State, pp. 372-80.

[87]Mautz and Sharaf, The Philosophy of Auditing, p. 133.

is placed on the auditor's level and quality of education which must rise proportionately.

Legal Environment

The effects of the legal environment on the general standards were discussed under definitions and interpretations of the standards. Generally, standards may be prescribed or defined by the legal profession in a manner different from that of the accounting profession. In addition, because the auditor has a legal responsibility to the public or third parties, his opinion may be "used to insulate the management and/or the board of directors from liability."[88] Such use of the auditor's opinion furthers the corporation's autonomy, preventing intervention from outside parties. That is, the opinion may be used by management to indicate the auditor approves the statements and assertions made in them. This use, in effect, causes the auditor to be responsible and liable to third parties for management's statements rather than properly placing the responsibility on management. Such possible misuse of the auditor's opinion must be recognized by the auditor and prevented through maintenance of independence and exercise of due care.

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[88]Hill, "The Public Accountants' Legal Liability to Clients and Others," p. 22.

Business or Economic Environment

The business or economic environment in which auditing is performed consists of three major elements--clients, investors, and public accounting firms. Since the general standards of auditing must change in interpretation with the changes taking place in the economy, the standards include awareness of and reaction to the economy's characteristics or circumstances.

Clients and Investors

The auditor's clients are to a large extent business firms, and their dominant form is corporate. This corporate form of business is characterized by the separation of the ownership and management functions which separation makes necessary the reporting by managers to owners of the results of operations and the firm's financial position. The auditor adds credibility to the reports of management by rendering an opinion as to the fairness of their presentation, and because the public, including owners, rely on his opinion, he is held to certain auditing standards. Otherwise, his opinion would have no credence. The initial separation of owners and managers increased the importance of the auditor's opinion because those supplying business capital were no longer able to make decisions as to its use. However, owners did have a voice through voting of shares on selection of the management. According to Adolf Berle, even that power of control through voting of shares has now been removed from individual owners so that a separation exists between owners, managers, and control over management through stockholder vote. The control of management has passed to institutional investors.

> The rise of the corporate system, with attendant separation of ownership from management due to concentration of industry in the corporate form, was the first great twentieth-century change. In three decades it led to rise of autonomous corporation management. The second tendency, pooling of savings, voluntary or forced, in fiduciary institutions now is steadily separating the owner . . . from his residual ultimate power--that of voting for management. In effect this is gradually removing power of selecting boards of directors and managements from these managements themselves as self-perpetuating oligarchies, to a different and rising group of interests--pension trustees, mutual fund managers and (less importantly) insurance company managements.
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> Pension trustees and insurance company managements have power (which thus far they have not exercised) to make management slates of their own and between them to elect those slates. But the return received by these institutions on these shareholdings is not theirs. It is destined for distribution among many millions of pension trust beneficiaries, mutual fund stockholders and policyholders.[89]

Although Berle points out that these institutional investors have not exercised their power in controlling managements, they have the potential for doing so.

> "Stockholders," of course, have always had this ultimate power over management. But while the stockholdings were diffused, widely separated, scattered into all manner of relatively small holdings, the stockholder in the main could not use his fractional power save in very rare instances.
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[89]Adolph Berle, Jr., Power Without Property (New York: Harcourt, Brace & World, Inc., 1959), pp. 59-60.

> The power location in stockholders was for practical purposes a fiction. The public opinion generated by stockholders probably was in the main a more effective check on management than the stockholders' votes. But directly there is a mobilization of these stockholders' voting power through accumulation of large percentages of stock, the power situation shifts. As of today, four or five pension trust or mutual fund managers, if they get together, are quite able to ignore the "management slates" for directors, get up slates of their own, and vote in their candidates. In place of the unorganized stockholders, none of whom has the energy or the money to mobilize his fellows, there are now centers of power already capable of carrying out such mobilization. Tomorrow these centers will be able, without having to ask assistance from individual stockholders, to deliver a controlling vote at will.[90]

As an illustration of the size of their stockholdings, "Institutions currently account for about 70% of the trades on the New York Stock Exchange."[91] Because of their activity and large stockholdings the Securities and Exchange Commission is seeking authorization to require these institutional investors to disclose their holdings.[92] The further separation of owners, managers, and control outlined by Berle has implications for auditing standards. The institutional investors, concentrating efforts of millions of stockholders, and their potential power with respect to management control influence the importance of auditing opinions on which they rely. Their concentrated power on the one hand can provide pressure for maintaining

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[90] Ibid., pp. 52-53.

[91] "Disclosure of Institutions' Stockholdings to Be Required by SEC if Congress Concurs," Wall Street Journal 26 April 1973: 3.

[92] Ibid.

independence against any client pressures on the other hand to compromise it. They can demand more, better, or different reports and thereby change the content of financial statements as well as the elements of competence and due care in field work and reporting. They also represent a potentially large legal liability in relation to the auditor's responsibilities for adhering to the general standards of auditing.

Aside from the feature of voter control over management exercisable by institutional investors, they are characterized as being very well informed--more so than the idea of a prudent investor connotes. In the past, auditing has based the criteria of fair presentation and adequate disclosure on the concept of a prudent investor, but with the rise of institutional investors, professional analysts, and professional investment counselors--all of whom are well informed--the basis of these criteria and, accordingly, auditing standards must change to reflect it.

> Auditing can no longer base its ideas of fair presentation on the concept of a reasonably informed investor who reads the published financial statements and makes his investment decisions accordingly. Today the investment market is a controlled market; further, it is one in which a number of skilled professionals all play highly integrated and highly important roles.
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> . . . .
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> . . . there should be a continuing effort by auditing to improve and extend its services, to keep up to date with the realities of the environment in which it operates. As a profession, auditing has significant social responsibilities; unless it accepts these social responsibilities it will not long merit the status of a profession.

> Among these responsibilities may well be included that of keeping abreast of the disclosure necessary to satisfy the needs of the investment market.[93]

Corporations have been described further by Galbraith who looks at the industrial system. While describing only one sector of the economy, his analysis is important because industrial corporations "comprise about half of the nonpublic sector as measured by their share of total product," and they are the part "which, almost automatically, we identify with the modern economy."[94] According to him, "It is the part that shapes out beliefs and values."[95] Assuming, then, that this sector of the economy is a strong influence within the business environment, its effects on auditing standards are important. The industrial corporation is characterized as depending on extensive planning, being guided by a group of people termed the technostructure, and requiring autonomy or freedom from outside interference in its planning and decision-making. Extensive planning becomes very important due to the nature of the production process which requires performance of tasks

> . . . that are right not for the time that they are undertaken but for the time in the distant future when they are completed. Developments, occurring between the time of initiation and the time of accomplishment, must be anticipated. Their effect, if adverse, must

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[93]Mautz and Sharaf, <u>The Philosophy of Auditing</u>, pp. 196-97.

[94]Galbraith, <u>The New Industrial State</u>, p. xxi.

[95]Ibid.

> be neutralized. Or the events must be prevented.
> . . . .
> The need for planning arises from the long period of time that elapses during the production process, the high investment that is involved, the inflexible commitment of that investment to the particular task, and the failure of the market when there is high technology.[96]

The decision-making of industrial corporations is performed by the technostructure which is described as being very large; extending from the most senior officials to white- and blue-collar workers; and embracing "all who bring specialized knowledge, talent or experience to group decision-making. This, not the management, is the guiding intelligence . . . of the enterprise."[97]

The planning function and, accordingly, the decision-making group or technostructure, require autonomy.

> Successful planning requires that the planning authority be able to control or sufficiently influence the various contingencies which bear upon the result it seeks. And it must not be subject to the power of those who might frustrate its plans either by ill-considered interference or even by carefully considered interference which reflects other and alien objectives.
> . . . .
> A prime requirement of the planning authority is control over its own decisions. This autonomy has, in fact, a double purpose. It is indispensable if the authority is to pursue the objectives of its planning. . . . It is also a vitally necessary aspect of decision-making under conditions of advanced technology.[98]

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[96]John Kenneth Galbraith, "The New Industrial State: Planning and the Modern Corporation," The Atlantic 219 (April 1967): 53-54.

[97]Galbraith, The New Industrial State, pp. 70-71.

[98]Galbraith, "The New Industrial State: Planning and the Modern Corporation," pp. 55-56.

The industrial corporation ensures this needed autonomy through its large size, having its own source of capital which includes adequate earnings, and the technical complexity of its decisions.[99] Implications for auditing from the industrial system's planning, technostructure, and need for autonomy cover all three of the standards. The auditor's competence must be commensurate with that of the technostructure and the complexity of its decision-making, operations, and financing. With emphasis and dependence on extensive planning comes a possible need for changes in the types of statements, such as forecasts, desired by investors. Such changes must be reflected in the competence standard. Independence must withstand the pressures on auditors to preserve the client's autonomy. Such pressures can come from the large size of industrial firms, their dependence on favorable earnings as a source of capital to maintain autonomy, and efforts by the technostructure to preserve itself and its plans. If forecasts, as a result of planning, are required, the auditor's independence also has to withstand pressures to publish financial statements indicating the forecasts were accurate. Due care is affected through greater responsibilities and possible liabilities inherent in auditing a large client with correspondingly large and complex operations.

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[99]Ibid., pp. 55-57.

In summary, the auditor's clients consist mainly of corporations characterized by large size; dependence on extensive planning and autonomy in decision-making; existence of a powerful decision-making group called the technostructure, and separation of ownership, management, and management control. Investors to whom auditors report include millions of people whose voting powers or management control is concentrated in a relatively few large investment institutions which involve investment analysts and counselors well informed in financial and other business matters.

Public Accounting Firms

The economic or business environment in which auditors function includes their employers--public accounting firms. These firms have been characterized as tending to be large in correspondence to the size of clients, somewhat lacking in professional solidarity, being operated in a businesslike way, and being closely allied with clients.[100] While large public accounting firms do not constitute the whole of accounting practice, they do account for a substantial portion of auditing work and exert a strong influence on the profession and its standards.

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[100]Mautz and Sharaf, The Philosophy of Auditing, pp. 211-18.

With the increase in size of corporations--that is, of auditing clients--accounting firms have increased in size to the extent that the profession is characterized by a small number of huge national firms.[101] This characteristic has both positive and negative implications for auditing standards. On the positive side, large firms can afford to provide auditors with considerable training and experience to meet the standard of competence. They also can afford specialists use of whom affects the total competence brought to bear on an audit. On the negative side, larger firms mean

> . . . more and more of the work of each is performed by employees. Hence direct knowledge of the details of the examination and the relations of his staff with the client's staff by the audit partner tends to decrease. However high the audit partner's personal standards of independence and professional dignity may be, maintenance of equally high standards throughout his staff presents a problem.[102]

Due care may be affected adversely by large size and the use of more and more employees if supervision of a large staff either is more difficult for the experienced auditors or is performed by less experienced auditors.

Professional solidarity refers to the support of one auditor for another when a client indicates a desire to change auditors.[103] Lack of professional solidarity fosters an atmosphere of competition for or solicitation

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[101] Ibid., p. 213.

[102] Ibid., p. 214.

[103] Ibid., pp. 215-16.

of clients, and this in turn is detrimental to the standard of independence since the auditor working in such an atmosphere could be faced with yielding to clients' pressures in order to initially obtain or retain them.

Large accounting firms tend to be operated in a businesslike manner because their continuance depends on a large volume of business. Operating in a businesslike fashion does not, in itself, prevent adherence to the standards, but it does detract from the emphasis on professional, as opposed to business, services.[104] Since the standards are based partly on the assumption of professionalism, a professional environment must be maintained for true adherence to them.

Public accounting firms are closely allied with business and specifically with the management of business firms. The close association of the two comes from dependence on clients for fees, confidential relationship with clients, and emphasis on management services.[105] This association has particular implications for independence and due care, both of which require recognition of primary responsibility to the public rather than to clients. Because the auditor works closely with management, he constantly is aware and is reminded of its needs and desires and therefore is likely to be subtly pressured

[104]Ibid., p. 214.

[105]Ibid., p. 211.

or influenced by it. Since the public is further removed from the day-to-day auditing work, responsibilities to it are more likely to be repressed.

Summarizing, the auditing standards exist in a business environment consisting of large clients, large and well-informed institutional investors, and large public accounting firms. While small accounting firms also are part of the environment, the larger firms exert most of the influence on the standards and the meaning of adherence to them.

Summary of the Auditor's Environment

Auditing is not performed in a vacuum or for its own sake but is a service responsive to the needs of society and business. As a service function, its standards--to be relevant--must reflect the type of environment in which they are applied. Elements of this environment range from aspects of society in general with its particular type of government, educational status, and legal institutions to the business or economic sphere with which auditing is directly associated. While the different aspects have varying degrees of influence, they all have some part in determining the meaning of adherence to auditing standards.

Summary

The meaning of adherence to the general standards of auditing reflects and is influenced by the standards' background partially including how they are defined and interpreted, their interrelationships, their underlying concepts, and their environment. In essence, this background consists of assumptions made about the standards and employed in the development of guidelines for adherence to them.

CHAPTER IV

TECHNICAL TRAINING AND PROFICIENCY

Introduction

> The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.[1]

The standard of adequate technical training and proficiency as an auditor aims at competency of a professional nature and level for the practice of auditing. Its possession is a prerequisite to the exercise of due care in the audit which exercise, along with maintenance of independence, justifies third parties' reliance on the auditor's examination and report. The importance of a professional degree of competence is illustrated in the following description of the type of judgments facing an auditor.

> In the course of his day-to-day practice, the independent auditor encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to examine and report upon the financial statements of a business

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[1]American Institute of Certified Public Accountants, Committee on Auditing Procedure, Statement on Auditing Standards: Codification of Auditing Standards and Procedures (New York: American Institute of Certified Public Accountants, Inc., 1973), p. 7.

> because, through his training and experience, he has become skilled in accounting and auditing and has acquired the ability to consider objectively and to exercise independent judgment with respect to the information recorded in books of account or otherwise disclosed by his examination. As a result, his opinion provides reasonable assurance that a fair presentation of pertinent information has been made in the financial statements.[2]

The emphasis of the standard as stated is on knowledge and proficiency attained through training and experience, but in order to make the type of judgments described above, the auditor must possess other attributes as well. Briefly, these other attributes have been described as "wisdom, perception, imagination, circumspection, judgment, integrity."[3] To be proficient as an auditor, his competence must include auditing knowledge and experience, but it also must include other fields of study relevant to his work. Therefore, guidelines for adequate technical training and proficiency as an auditor extent to attributes other than technical knowledge and training and to all areas relevant to the practice of auditing. The assumption is made that an auditor's competence covers not only his personal qualifications but also those of his staff, associates, and others on whom he relies.

> The accountant holds himself out as one who is proficient in accounting and auditing. In addition, he asserts that those who work for him have the

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[2] Ibid., p. 8.

[3] Robert H. Roy and James H. MacNeill, Horizons for a Profession (New York: American Institute of Certified Public Accountants, Inc., 1967), p. 1.

> necessary amount of training and ability to do the jobs assigned to them and that they are properly supervised.[4]

However,

> . . . the responsibility does not even stop here. Every practicing accountant has a duty to know that, not only he and his employees, but also those with whom he is associated in practice or on whom he relies in any relationship are adequately prepared.[5]

Another assumption employed in developing guidelines for competence is that the same standard is applied to all auditors without regard for different levels of intelligence, education, or experience. In the case of inexperienced auditors, the assumption is they are properly supervised by more experienced auditors to ensure the total degree of competence brought to bear on the audit meets the standard's requirements.

While no absolute test of competence exists, the auditor does need some means of evaluating his competence before undertaking an engagement. This need follows from his ethical responsibility to undertake only those engagements for which he has adequate technical training and proficiency.

> Observance of the rule on competence calls for a subjective determination by a CPA with respect to each engagement. Some engagements will require a higher level of knowledge, skill and judgment than others.

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[4]Carman G. Blough, "Auditing Standards and Procedures," The Accounting Review 24 (July 1949): 266.

[5]Edward B. Wilcox, "Professional Standards," in CPA Handbook, ed. Robert L. Kane, Jr., 2 vols. (New York: American Institute of Accountants, 1956), 2, ch. 13: 7.

> Competence to deal with an unfamiliar problem may be acquired by research, study or consultation with a practitioner who has the necessary competence. If a CPA is unable to gain sufficient competence through these means, he should suggest, in fairness to his client and the public, the engagement of someone competent to perform the needed service, either independently or as an associate.[6]

The intent of the guidelines is to provide the auditor a means for evaluating his competence before he undertakes audit engagements. Accordingly, the guidelines are discussed under the meaning of competence, its indicators, and the process of evaluating it.

Meaning of Adequate Technical Training and Proficiency

Adequate technical training and proficiency as an auditor means possession of knowledge, abilities, and skills which are relevant to auditing; which have been acquired through formal education, training and experience, or continuing education; and which are at least equal to those of the average practitioner in good professional standing. These aspects of competence may be referred to as its content, its sources, and its measure.

Content of Competence

"Professional service rests on relative mastery of a relevant body of knowledge on the one hand and relative

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[6]American Institute of Certified Public Accountants, Code of Professional Ethics (New York: American Institute of Certified Public Accountants, Inc., 1972), p. 11.

mastery of a professional craftsmanship on the other."[7] Craftsmanship encompasses the abilities and skills necessary for using the knowledge already possessed or determining the knowledge to be acquired for handling audit situations. The content, then, of technical training and proficiency consists of these three components.

Knowledge

Knowledge is defined as "the recall of specifics and universals, the recall of methods and processes, or the recall of a pattern, structure, or setting."[8] Included in this definition are "the hard core of facts or information" in a field of study, such as terminology, for understanding and systematically organizing it; "the ways of organizing, studying, judging, and criticizing ideas and phenomena" in the field including its conventions, trends and sequences, fundamental classifications and categories, criteria for judgment formation, and methodology; and "the large structures, theories, and generalizations which dominate" the field.[9] Knowledge develops an acquaintance

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[7]G. Lester Anderson, "Professional Education: Present Status and Continuing Problems," Education for the Professions in The Sixty-first Yearbook of the National Society for the Study of Education, pt. 2 (Chicago: The National Society for the Study of Education, 1962), p. 18.

[8]Benjamin S. Bloom, ed., Taxonomy of Educational Objectives. Handbook I: Cognitive Domain (New York: David McKay Company, Inc., 1956), p. 201.

[9]Ibid., pp. 62-76.

with the realities of a field of study and its environment as currently known or accepted by its experts and authorities; is basic to problem solving, thinking, and the development of abilities and skills; and accords status to individuals in that its possession indicates intelligence and maturity.[10]

Knowledge required for entering the accounting profession has been described by Roy and MacNeill as the common body of knowledge for certified public accountants, and it includes the areas of accounting, the humanities, economics and behavioral science, law, mathematics, statistics, probability, and the functional areas of business--finance, production, marketing, and personnel relations and business management.[11] More specific guidance for acquiring this common body of knowledge appears in the so-called Beamer Report which consists of an educational program for implementing the objectives of <u>Horizons for a Profession</u>.[12] Beyond attaining possession of this initial body of knowledge required for entry into the profession, competence includes knowledge of a current and continuing nature so that the auditor's technical

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[10]Ibid., pp. 32-35.

[11]Roy and MacNeill, <u>Horizons for a Profession</u>.

[12]American Institute of Certified Public Accountants, Committee on Education and Experience Requirements for CPAs, <u>Academic Preparation for Professional Accounting Careers</u> (New York: American Institute of Certified Public Accountants, Inc., 1968).

training and proficiency is updated as well as improved over his career.

Abilities and Skills

Abilities and skills are necessary for using the knowledge one has. While they do overlap in meaning, the distinction between them is that skills are developed, not inborn qualities.

> As used here, a skill implies an ability which can be developed, not necessarily inborn, and which is manifested in performance, not merely in potential. So the principal criterion of skillfulness must be effective action under varying conditions.[13]

Abilities important in technical training and proficiency have been identified as comprehension, application, analysis, synthesis, and evaluation.[14] Respectively, they refer to the abilities to use abstractions such as theories, ideas, principles, or generalized models;[15] to transfer knowledge acquired through education to actual practice involving new situations;[16] to break down material into its component parts, discerning the relationships involved and distinguishing relevant from extraneous material;[17] to form a whole from individual

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[13]Robert L. Katz, "Skills of an Effective Administrator," Harvard Business Review 33 (January-February 1955): 33-42.

[14]Bloom, Taxonomy of Educational Objectives. Handbook I: Cognitive Domain, pp. 204-207.

[15]Ibid., pp. 89-98, 204-205.

[16]Ibid., pp. 120-30.

[17]Ibid., pp. 144-48, 205-206.

elements of a situation such that the entire situation has meaning beyond that of a mere collection of elements;[18] and to form value judgments of either a quantitative or qualititative nature.[19]

Skills necessary for competence have been defined as technical, human, and conceptual skills.[20] Technical skill is "an understanding of, and proficiency in, a specific kind of activity, particularly one involving methods, processes, procedures, or techniques." It "involves specialized knowledge, analytical ability within that specialty, and facility in the use of tools and techniques of the specific discipline." The main emphasis of technical skill is "working with 'things'" such as processes or physical objectives.[21] For auditors, "technical skill relates to the performance of accounting, auditing, tax or management advisory services for clients."[22] While indispensable to the practice of auditing, it is most important at the lower or junior positions. As the auditor progresses, he is assumed to have the requisite technical skills, and the development of other skills becomes more important.

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[18] Ibid., pp. 162-72, 206-207.

[19] Ibid., pp. 185-95, 207.

[20] Katz, "Skills of an Effective Administrator," p. 34.

[21] Ibid.

[22] William G. Shenkir and Thomas L. Wheelen, "Three Dimensional Staff Development," The Journal of Accountancy 132 (July 1971): 83.

Human skill emphasizes working with people and involves the "ability to work effectively as a group member and to build cooperative effort." It refers to an individual's sensitivity with regard to himself and others such that he can

> . . . (a) recognize the feelings and sentiments which he brings to a situation; (b) have an attitude about his own experiences which will enable him to re-evaluate and learn from them; (c) develop ability in understanding what others by their actions and words (explicit or implicit) are trying to communicate to him; and (d) develop ability in successfully communicating his ideas and attitudes to others.[23]

To a large extent, human skill depends on an individual's natural make-up or personality, not just on his basic intelligence. For auditors, it is needed at two levels--inside the audit firm and outside it. Within the firm, "human skill relates to the CPA as a group member of a firm and more specifically as a member of an audit staff assigned to a given engagement." Its meaning is summarized by the phrase "competence in the art of collaboration" and refers to the abilities of working and cooperating with other people, being "sensitive to the opinions and feelings of the other members of the audit team," and striving "to create an atmosphere where subordinates will be motivated to offer their opinions on how best to accomplish the assignment." Outside the audit firm, human skill is needed in relationships with people external to the firm--

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[23]Katz, "Skills of an Effective Administrator," p. 40.

clients' employees who furnish or help in gathering evidence and other professionals such as lawyers and internal revenue agents.[24] Human skill is essential at every position within the audit firm and

> . . . seems to be most important at lower levels, where the number of direct contacts between administrators and subordinates is greatest. As we go higher and higher in the administrative echelons, the number and frequency of these personal contacts decrease, and the need for human skill becomes proportionately, although probably not absolutely, less.[25]

Conceptual skill is defined as involving

> . . . the ability to see the enterprise as a whole; it includes recognizing how the various functions of the organization depend on one another, and how changes in any one part affect all the others; and it extends to visualizing the relationship of the individual business to the industry, the community, and the political, social, and economic forces of the nation as a whole.[26]

Like human skill, the auditor needs conceptual skill at two levels--the level of the audit firm and the level of the particular audit engagement. At the firm level it means understanding the organization as a whole, how the various elements function together as a unit, and, for the individual auditor, how he fits into the total scheme. At the level of the audit engagement, conceptual skill means understanding the client's business in its entirety, the goals of the audit, the relationships among various audit

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[24]Shenkir and Wheelen, "Three Dimensional Staff Development," pp. 83-84.

[25]Katz, "Skills of an Effective Administrator," p. 37.

[26]Ibid., pp. 35-36.

steps and procedures to achieve the goals, and, for the individual auditor, the relationship of his area of responsibility to the entire business and audit. Conceptual skill is most relevant to the higher and more responsible positions within the audit firm.[27] The content of an auditor's technical training and proficiency should not only cover various topics but also should meet several criteria. In general, knowledge, abilities, and skills should be useful and relevant to the field of auditing, applicable to both immediate and future needs, and normative as well as positive in nature. Usefulness and relevance to the field of auditing mean competence includes fields of study directly concerned with auditing practice and those areas not directly related to practice but a part of the overall field of auditing. An example is auditing history which is relevant to auditing but not used directly in practice. Applicability to immediate and future needs of auditing means the auditor has the competence to practice auditing as it presently exists and has a basis for meeting future auditing needs and adjusting to change.[28] This latter goal is accomplished through continual awareness of new developments in auditing, or

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[27]Shenkir and Wheelen, "Three Dimensional Staff Development," p. 84.

[28]Norton M. Bedford, The Future of Accounting in a Changing Society (n.p.: Stipes Publishing Company, 1970), pp. 40-41.

current knowledge and skills. Continual awareness also describes an attitude of mind encompassing alertness to change or situations which precipitate change, intellectual curiosity, analysis of the effects of changes and personal preparation for them, reflecting thinking or the development of insight and vision, and thinking in abstract terms so the mind "turns readily to the invention of new treatments and alternatives."[29] Positive aspects of competence refer to these elements of training and proficiency which presently exist in auditing practice while normative aspects are those elements necessary in recognizing the need for changes and overcoming resistance to change. The auditor "must gain an understanding of the framework within which a normative system of accounting can be developed and periodically adjusted to changing environments."[30] Normative concepts regarding accounting and auditing provides a standard against which positive concepts can be measured, contrasted, or analyzed for modification--an important quality of competence because "auditing is concerned not only with discovering what its concepts now are but also with what they ought to be."[31]

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[29]R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (Menasha, Wisconsin: George Banta Company, Inc. for the American Accounting Association, 1961), p. 35.

[30]Joshua Ronen, "Accounting Education in the Light of New Developments in the Profession--Part I," Canadian Chartered Accountant 103 (September 1973): 71.

[31]Mautz and Sharaf, The Philosophy of Auditing, p. 65.

Sources of Competence

The sources of competence in auditing are formal education, training and experience, and continuing professional education. Formal education is the source from which the auditor begins to acquire competence of a professional nature, and it should provide the common body of knowledge necessary for entering the profession. Since formal education usually is acquired before beginning an auditing career, it provides the foundation for further professional development and education. Qualities of competence to be developed by formal education, as discussed by Joshua Ronen, include the following: learning with understanding as opposed to rote learning alone, divergent as well as convergent thinking, and awareness of future demands which will be made and for which the auditor must be prepared. These qualities are essential for realizing the nature and limits of the knowledge of a field; for critically evaluating existing knowledge; for adapting to changing circumstances; and for replacing obsolete rules, techniques, procedures, and information when better ones are found.[32] Formal education is an important source for broad background as well as specific and technical knowledge in auditing, but it probably is the most important source for those areas in which the auditor is not expected

[32]Ronen, "Accounting Education in the Light of New Developments in the Profession--Part I," pp. 69-70.

to be experienced. For example, auditors are not experienced necessarily as accountants or as business managers. However, they are expected to be competent in these areas, and they must rely heavily on formal education as the basis for their proficiency in them. Some proficiency in accounting and business is acquired indirectly through auditing experiences, but in areas, such as mathematics and statistics, formal education may be the only source for both general and technical competence. In summary, formal education as a source of competence should provide the following:

1. The broad theoretical instruction basic to proficient practice
2. The specialized knowledge and technical skills which characterize a given profession and distinguish it from others
3. The general education outside the vocational field needed by all citizens, regardless of their chosen work, to discharge their civic duties properly and to live an informed and effective personal life.[33]

Training and experience as sources of competence are extensions of the auditor's formal education, being the application of formally learned knowledge and skills to actual auditing practice.[34] While formal education

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[33]Earl J. McGrath, "The Ideal Education for the Professional Man," Education for the Professions in The Sixty-first Yearbook of the National Society for the Study of Education, pt. 2 (Chicago: The National Society for the Study of Education, 1962), p. 283.

[34]Donald L. Madden and Lawrence C. Phillips, "An Evaluation of the Common Body of Knowledge Study and Its Probable Impact Upon the Accounting Profession," The Journal of Accountancy 125 (February 1968): 87.

generally is acquired before embarking on a career, experience is important and is acquired throughout it. Training and experience are especially important in acquiring the technical proficiency required in auditing.

> Any neophyte practitioner who attempts to put his theoretical knowledge to use in the varied circumstances of daily practice recognizes that, though knowledge may be power, it is often latent rather than active. Only as he acquires the technical, intellectual, and manual skills to use these can the value of theoretical knowledge be realized. . . . practical experience is indispensable to vocational competence.[35]

In specific areas, training and experience sharpen and increase the auditor's knowledge and technical skills for field work and reporting activities, develop his human skills from working with other people, develop his abilities to make decisions and form judgments or opinions in various audit situations, increase his understanding of accounting and business through contact with different accounting systems and types of businesses, and can sharpen his proficiency in using such tools of analysis as statistics. Over all the areas of competence, training and experience give the auditor an awareness of the implications of professionalism and develop his personal attitudes reflected as a professional image, self-confidence, appreciation of professional ethics, and awareness of the level of competence expected of professionals.[36]

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[35]McGrath, "The Ideal Education for the Professional Man," p. 289.

[36]William C. Bruschi, "Issues Surrounding Qualifying

Continuing professional education represents a source of competence which prevents obsolescence on the part of the auditor by keeping him "intellectually alive and broadly informed after he discontinues his formal higher education."[37] It is important in all areas of competence as "a before-the-fact attempt to eliminate sub-standard practices rather than an after-the-fact disclosure of such practices."[38] The means for continuing education include formal education, training, and experience additional to that initially acquired before or immediately on entering the profession. These means may be in the form of courses of study provided by public accounting firms, accounting societies, and educational institutions or in the form of self-study such as reading current professional literature and official publications and associating with other professional auditors.

The need for continuing education as a source of auditing competence derives from several reasons, the main ones being the rapid expansion of knowledge in society as a whole, the enlargement of areas affecting public accounting, and the auditor's individual limitations. Elmer

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Experience Requirements," The Journal of Accountancy 127 (March 1969): 49.

[37]McGrath, "The Ideal Education for the Professional Man," p. 284.

[38]V. C. Lembke, J. H. Smith, and V. H. Tidwell, "Compulsory Continuing Education for CPAs," The Journal of Accountancy 129 (April 1970): 63.

Beamer has described the effect of the "knowledge explosion" on the continuing education aspect of auditing competence.

> One of the most dramatic phenomena of our times is the explosion of knowledge. It has been estimated that man's knowledge doubled between the year 1900 and 1950 and that it will double again by 1975. Some have suggested that it will double every five years or less. In the face of this phenomenon, CPAs, like those in other kinds of activity, must continue to learn. Simply put, continuing education is the alternative to obsolescence.[39]

Occurring with, and at times because of, this expansion in knowledge is expansion of the areas affecting auditing. It, too, demands continuing education by the auditor.

> . . . the function of the accountant is one which is continually evolving, not only because of the extension of knowledge and development of new methods but because of the enlargement of the area in which the particular knowledge, skill, method and judgment of a person experienced in exercising the function of accountant are recognized as being relevant in dealing with matters of government, administration and business management.[40]

The auditor's personal limitations--whether due to his educational background, lack of experience, or aptitude--require continuing efforts at improvement. Besides overcoming limitations or deficiencies, continuing education sharpens the knowledge and skills already possessed.

Measure of Competence

The adequacy of technical training and proficiency is a minimum condition to be met by the auditor, and it is

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[39]Elmer G. Beamer, "Continuing Education--A Professional Requirement," The Journal of Accountancy 133 (January 1972): 34.

[40]David Flint, "The Accounting Function Tomorrow," The

measured against the competence possessed by the average or prudent practitioner in good professional standing. That is, the auditor at least must be as competent as the average auditor.[41] This measure has two meanings in that it refers to the amount of knowledge and skill needed and to its quality--the degree of precision, facility, or proficiency needed in regard to the various elements of competence.[42] The criterion is transitory in nature because it rests on changing concepts. The community of auditors from which the average or prudent practitioner concept is defined and against which the individual auditor's competence is measured changes in terms of the men composing it and their degrees of competence. For example, as more members of the accounting profession acquire graduate degrees, the level of education attained by the average practitioner rises, and the individual's competence, to be considered adequate, must contain more knowledge and skills from formal education. As the community of auditors in general attains greater proficiency, the degree of precision or quality ascribed to competence also rises. The application of this measure in determining adequacy of

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Accountant's Magazine 72 (January 1968): 12.

[41]See American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 7; and Mautz and Sharaf, The Philosophy of Auditing, pp. 131-39.

[42]Bloom, Taxonomy of Educational Objectives, pp. 36-37.

technical training and proficiency is assumed in the discussions of the indicators and evaluation of competence.

Indicators of Adequate Technical Training and Proficiency

Indicators of adequate technical training and proficiency are possession of the minimum knowledge required for entry into the profession, training and experience, performance as an auditor, and continuing professional education.

Minimum Knowledge

Admission to the profession and particularly designation as a certified public accountant are indicators that the auditor has the minimum knowledge necessary for entering auditing practice. This follows from the requirement that candidates for admission to the profession must prove "mastery of the common core of knowledge that all CPAs should possess."[43] In regard to obtaining the CPA certificate, Wilcox noted

> Adequate technical training can scarcely be understood to mean less than this goal, and the practitioner who has not formally achieved it, but who nevertheless lays claim to observance of generally accepted auditing standards assumes the burden of establishing that his training is adequate.[44]

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[43]American Accounting Association, Committee to Compile a Revised Statement of Educational Policy, "A Restatement of Matters Relating to Educational Policy," The Accounting Review 43 (Supplement 1967): 100.

[44]Wilcox, "Professional Standards," p. 6.

Proof that the auditor has mastered the common core of knowledge for CPAs and designation as a certified public accountant basically depend on passing the CPA examination and attaining a level of higher education comparable to that of other professional auditors. Passing the CPA examination mainly indicates the auditor possesses knowledge of special areas particularly related to auditing practice--areas such as accounting, auditing, taxes, and management services.[45] Since all the competence qualifications desirable in auditors cannot be tested in the short period of time given to the CPA examination,

> . . . the profession must depend primarily upon formal educational requirements as evidence that the candidate possesses the broad general knowledge and cultural background needed by the CPA.[46]

As an indicator of competence, passing the CPA examination and attainment of formal education are most useful at the time of entrance to the profession.

> Satisfaction of the requirements for the CPA certificate is evidence of basic competence at the time the certificate is granted, but it does not justify an assumption that this competence is maintained without continuing effort. Further, it does not necessarily justify undertaking complex engagements without additional study and experience.[47]

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[45]American Accounting Association, "A Restatement of Matters Relating to Educational Policy," pp. 100-102.

[46]Ibid., p. 100.

[47]American Institute of Certified Public Accountants, <u>Code of Professional Ethics</u>, p. 11.

Training and Experience

While educational level attained and passing the CPA examination indicate basic competency in auditing, acquisition of training and varied experience indicates the auditor's professional development and adequate competence for making responsible decisions and judgments.

> Every practical man knows that experience is the cream of education. It is only after experience has been added to formal training that the standards of proficiency necessary to full responsibility can be attained.[48]

The value of experience as an indicator of adequate competence depends on its quality and variety as well as on the quality of supervision and review exercised over the auditor.

> The value of experience cannot be measured in terms of time. Measurement must be in terms of varied tasks and how well these tasks are performed. Little new knowledge is learned from repetitious experience. A junior who reconciles sixty bank statements actually has the experience of reconciling one bank statement sixty times.[49]

The more varied is the auditor's experience, the greater is his exposure to different audit situations, accounting systems, and business problems leading to a wider range of competency. Variety is achieved through such means as rotation among different audit clients and among the various parts of the audits.

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[48]Wilcox, "Professional Standards," p. 7.

[49]Bruschi, "Issues Surrounding Qualifying Experience Requirements," p. 51.

Performance as an Auditor

Performance as an auditor indicates professional development and is manifested in the auditor's demonstration of abilities and skills in his advancement within the audit firm. Indications of competency through successful use of various skills are illustrated in the following examples: technical ability is demonstrated through proper use of auditing techniques, procedures, and methods; human skills are demonstrated in effective communication with subordinates, peers, or supervisors, leading to attainment of the desired audit results; conceptual skills are demonstrated in forming good judgments and reasonable decisions. The auditor can rely to a great extent on supervisors' opinions as indicators of the quality of his performance as an auditor, but indicators of a personal nature also exist. These indicators are self-assurance or confidence in making decisions or forming judgments and self-reliance in, for example, being able to determine for himself belief versus doubt when solving problems or drawing conclusions. As the auditor gains experience and develops professionally, he should improve his skills, which improvement leads to self-assurance and greater self-reliance. Thus, self-assurance and self-reliance indicate adequate competence on the part of the auditor.

Advancement within the firm indicates the opinion more experienced auditors have of the individual's proficiency and consequent quality of his work. That opinion is illustrated in assignments of increasing responsibility and difficulty as well as in promotions at a rate at least equal to that of the average practitioner within the firm. A description of increasing responsibilities corresponding to firm advancement has been given by Estes.

> . . . he becomes responsible for administering an engagement, handling relations with clients, supervising and training his subordinates, performing at an executive rather than at a subordinate level, major decision-making, and representing the profession before the public. . . .[50]

The auditor, then, can view his assignments and advancement as indicators of adequate technical training and proficiency as judged by more experienced auditors.

Continuing Professional Education

Continuing professional education is indicative of several aspects of competence among which are the following:[51]

1. "catch-up education" in areas for which the minimum knowledge and skills necessary for entry into the profession have not been attained;

2. current knowledge or the auditor's "continual awareness of developments taking place in business and in

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[50]Ralph W. Estes, "Professional Education for the Mature Accountant," Canadian Chartered Accountant 92 (March 1968): 193.

[51]Joseph O'Rourke, "The Role of Colleges and Universities in Professional Development," The Journal of Accountancy 135 (March 1973): 92.

his profession;"[52]

3. enlargement of the scope of knowledge and skills to new areas such as forecasts;

4. more extensive development of proficiency in areas of specialty;

5. continual renewal of the auditor's existing knowledge base to prevent obsolescence particularly in those areas lacking use by the auditor.

Evidence the auditor has continued his professional education includes his being well informed on current developments in the profession and in business generally; his being able to apply current techniques and procedures; his being able to change with changes in business and technology as, for example, in being able to audit highly complex computer systems; his having been exposed to continuing education programs and courses of study, especially exposure to additional formal educational experience;[53] and his having firm support for continuing education in the form of a proper environment including time and financial support, continuing education programs, and stress on self-development.[54]

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[52]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 8.

[53]Lembke, Smith, and Tidwell, "Compulsory Continuing Education for CPAs," pp. 62, 64-65.

[54]Milton F. Usry, "The Meaning of Professional Development," The Journal of Accountancy 135 (May 1973): 89-91.

Summary of Competence Indicators

Indicators of adequate technical training and proficiency as an auditor have been described as possession of the minimum knowledge necessary for entering the profession evidenced by the level of formal education attained and passing the CPA examination; training and varied experience in auditing situations; successful performance as an auditor evidenced by firm advancement, increasing responsibilities, self-assurance, and self-reliance; and continuing professional education to acquire additional competence, to improve it, or to enlarge its scope. Each of the indicators is important in its own way, being relevant to particular aspects of auditing competence. Therefore, attention should be given to the combined effect of the indicators taken as a whole rather than placing emphasis on any one indicator. As implied by the term "indicators", they do not prove the existence of adequate competence; they only suggest its existence.

Evaluation of Technical Training and Proficiency

The standard of adequate technical training and proficiency as an auditor is a personal standard, and, as such, it demands of the auditor a personal evaluation of his own competence. As mentioned in the introduction, the auditor ethically is responsible for undertaking only those engagements for which he is adequately competent.[55] Because of the reliance others, particularly the public, place on his work, he also is responsible legally for evaluating his competence to engage in the work of an audit.

> One of the things a man may know is his own ignorance, and this in itself may often be found to call for precautions against possible but unknown danger.[56]

The precautions for an auditor to take if he lacks the requisite competence are acquiring the necessary competence or refusing to undertake the engagement. Undertaking engagements for which he is not adequately competent results in negligence.

> It is not necessary that the actor should realize that the circumstances surrounding him are such as to make his conduct likely to cause harm to another. It is enough that he should realize that his perception of the surrounding circumstances is so imperfect that the safety or danger of his act depends upon circumstances which at the moment he neither does nor can perceive. In such case it is negligent for him to act if a reasonable man would recognize the necessity of making further investigation.[57]

Given that the auditor ethically and legally must evaluate the adequacy of his competence before undertaking audit engagements, attention is focused on a process of evaluation which he can employ with regard to this personal quality.

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[55]American Institute of Certified Public Accountants, Code of Professional Ethics, p. 11.

[56]2 Harper and James, The Law of Torts 908 (1956).

[57]2 Restatement of the Law: Torts 44 (2d ed. 1965).

In evaluating his competence, the auditor does have available some tools to help or guide him. They are an understanding of the meaning of adequate technical training and proficiency as an auditor and indicators of competence both of which are included as guidelines for the standard. The test of competence lies in its application to practical audit situations, a test ultimately judged by others--the auditor's supervisors or his peers in the case of partners--and applied to the quality of his work. For the auditor who has not attained the level at which he has final responsibility for an audit or at which he is in full charge of it, the evaluation of his competence is, to a large extent, the responsibility of those who assign him audit work and who rely on his work. However, even he must judge whether he can execute the assignments given him without assistance or further study rather than blindly assuming he is competent simply because he has been given them.

The process of evaluating competence involves several steps which the auditor can follow. A basic contention is that he can know the extremes of his competence--that is, he can know the areas in which he has very limited competence and the areas in which he has competence of an especially high quality or in which he is an expert or specialist. Generally, knowing areas of expertise is a simpler task than admitting limitations. These areas are ones about which the auditor can most easily converse with other recognized experts, is looked to for advice, is current, and is most interested. Other professionals recognize him as an expert in such areas and hold him to that status. Areas of limited competence, however, may require more painful recognition and personal control.

> . . . it is sometimes quite difficult for a practitioner to limit himself because his training or experience has been limited. Yet this is an exercise in self-discipline which is clearly required by the standard of proficiency. . . . Even if the practitioner has met high standards of general training and proficiency, and has developed a wealth of experience in his practice, he may have had no experience in certain fields. . . . Competent as he may be in the areas of his experience he may not be sufficiently competent in some of those areas which lie outside it. In some such circumstances his general experience and training may enable him to compensate for specific inexperience by special preparation, but unless he can and does do this it would be no more proper for him to undertake such work than it would be if he had no training whatever.[58]

Between these extremes in proficiency, the auditor evaluates his competence to handle various audit assignments. One step in the process is to compare his personal situation with the meaning of adequate technical training and proficiency as an auditor and with its indicators. For example, he first can compare the level of formal education he has attained and his performance on the CPA examination to that required for entry into the profession as indicators of at least the minimum knowledge required.

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[58]Wilcox, "Professional Standards," p. 7.

Second, he can review his training and experience as evidence he has had exposure to similar audit situations and, in the past at least, has successfully demonstrated adequate competence as determined by his supervisors. The fact that he has been given responsibility for the assignment demonstrates his superiors have judged him competent in that regard. Third, his personal feelings of self-assurance, or confidence, and self-reliance give some indication of competence. However, this indicator must be tempered with the realization that being overly confident could lead to his accepting assignments which in reality he is not competent to undertake and to his failure to acquire the necessary competence if his is inadequate. Fourth, he can look to his involvement in continuing professional education as evidence he has been exposed to the area for which he assumes responsibility, has kept his knowledge of it current, and has learned current audit techniques relevant to it.

Beyond this comparison of the auditor's personal situation with indicators of competence, other steps in the process of evaluation include gathering evidence that he has made attempts to acquire the required competence through additional study or investigation into the problems at hand, by determining that he is under the supervision of more experienced auditors to whom he can look for assistance and on whom he can rely for review of his work, and by engaging the services of a specialist or expert for assistance in areas for which he lacks the necessary competence but for which he nevertheless is responsible. In addition, he can consider whether his perception of the circumstances is based on competence adequate to his foreseeing the risk of harm to others which may result as a consequence of his work. That is, the auditor must be competent enough to realize the future consequences involved in others' reliance on his examination and opinion.

The process of evaluating competence involves conscious efforts by the auditor to review his qualifications for undertaking audit assignments and to reflect on his actual mental state of belief that he is adequately competent. The process is not infallible. It is simply a means of personal evaluation employed in addition to the evaluation by superiors. Its implementation depends on the auditor's sense of responsibility to third parties, to clients, to the audit firm with which he is associated, to the accounting profession, and to himself. Altruistically, it is based on the desire to be of service to others. More selfishly, and probably more realistically, it is based on the practical need to avoid adverse legal and professional repercussions from negligently accepting responsibility for audit engagements in which he lacks the necessary competence and in which he therefore cannot exercise due professional care.

Summary and Conclusions

Adherence to the standard of adequate technical training and proficiency as an auditor requires the individual auditor to evaluate his own competency to undertake auditing engagements. This personal evaluation depends on his understanding the meaning of the standard and recognizing indicators of its adequacy. Consequently, guidelines for the standard include its meaning, its indicators, and its evaluation. These guidelines, being relevant to a personal evaluation, constitute only one, intermediate test of competence to be applied before audit engagements are undertaken. Ultimate testing resides with the auditor's supervisors who review his work and who judge the quality or adequacy of competence embodied in the work.

CHAPTER V

INDEPENDENCE

Introduction

> In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.[1]

Importance and Objectives of the Standard

The importance or reason for existence of independence is derived from conditions present in the auditor's working environment. These conditions have been identified in "A Statement of Basic Auditing Concepts" as a conflict of interest, consequence, complexity, and remoteness.[2]

An actual or potential conflict of interest between the user and preparer of financial statements leads to concern over the possibility of either deliberate or unintentional bias in the statements and "makes it mandatory that the audit function be performed by one who is

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[1]American Institute of Certified Public Accountants, Committee on Auditing Procedure, Statement on Auditing Standards: Codification of Auditing Standards and Procedures (New York: American Institute of Certified Public Accountants, Inc., 1973), p. 8.

[2]American Accounting Association, Committee on Basic Auditing Concepts, "Report of the Committee on Basic Auditing Concepts," The Accounting Review 47 (Supplement 1972): 25.

independent of the preparer and his interests."[3] Where users of published financial information base decisions of significant consequence on that information, importance is attached to its quality and to assurance it contains no "biased, misleading, irrelevant, or incomplete information" which could result in incorrect and harmful decisions. Control over the quality and, therefore, the necessary assurance are supplied by independent auditors whose opinions lend credibility to the information.[4] Complexity of the subject matter in published financial statements calls for a level of expertise in judging its quality. Since the required expertise is not possessed by users of the information, they must instead rely on auditors who are competent to form such judgments.[5]

> Independence becomes important because the interested party, the stockholder or creditor or the like, has no way to evaluate objectively the work performed by the public accountant and the recommendations, if any, made by him, except as the work performed is reflected in his opinion.[6]

Remoteness, the separation between users and preparers of financial statements, may be due to any of several reasons including physical separation, institutional and legal

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[3] Ibid., pp. 26, 31.

[4] Ibid., pp. 26, 29.

[5] Ibid., p. 26.

[6] Thomas W. Hill, Jr., "The Public Accountants' Legal Liability to Clients and Others," The New York Certified Public Accountant 38 (January 1968): 29.

barriers to access to the information and its preparer, time, and cost. Remoteness prevents the user's evaluating the statements for himself, and it thereby creates the need for an opinion regarding them by an independent auditor.[7]

Independence as a personal qualification of the auditor, then, is important as a means of control over bias in published financial statements--statements which users cannot judge in terms of bias for themselves due to the presence of one or more of the above conditions.

> Above all else, especially where the conditions of conflict of interest and remoteness are paramount, . . . the primary value added by the audit function is a control over bias, both deliberate and unintentional, affecting the information contained in accounting reports. If an audit under such conditions does not provide the users with some assurance that accounting information is reasonably free from undisclosed bias, it provides little, if any, value to the process of communication of accounting information. It is for this reason that independence is the *sine qua non* attribute of an auditor.[8]

The user's confidence in control over bias means the auditor's opinion adds credibility to the published statements[9]--a credibility justified by his independence which is an obligation to be fulfilled "even when it means opposing and denying the wishes of those who

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[7]American Accounting Association, "Report of the Committee on Basic Auditing Concepts," p. 26.

[8]Ibid., p. 29.

[9]Ibid.

have employed him, and who, he knows, may cease to do so."[10]

Closely related to the importance of independence are its objectives in meeting users' needs for control over bias and added credibility. Since independence is a personal standard, its objectives relate to the auditor's qualifications and the quality of his work.[11] The basic objective is an independent auditor, one "without bias with respect to the client under audit"[12] and one whose opinions are "based on an objective and disinterested viewpoint."[13] Such a viewpoint, in turn, is obtained through impartial and objective considerations in field work and is disclosed through unbiased reporting.

Scope of the Discussion

The discussion of guidelines for independence aims at a better understanding than now exists of the standard and its application in practical audit situations. This aim takes into consideration several assumptions and

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[10]Edward B. Wilcox, "Professional Standards," in CPA Handbook, ed. Robert L. Kane, Jr., 2 vols. (New York: American Institute of Accountants, 1956), 2, ch. 13: 8.

[11]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 7.

[12]Ibid., p. 8.

[13]Louis H. Rappaport, SEC Accounting Principles and Procedure, 3d ed. (New York: Ronald Press Company, 1972), p. 26.1.

limitations placed on the maintenance of independence. An important limitation is that independence in a literally pure or absolute sense is probably impossible to achieve because auditors cannot avoid all possible pressures upon their independence and continue to practice.[14] Unavoidable pressures are due, in large part, to results of the characteristics of the auditor's working environment. These characteristics are later considered in the discussion of conditions having a possible adverse effect on independence, but they include, for example, the auditor's economic dependency on clients; his being selected or employed as auditor by the firm's executives rather than its shareholders; at times, his necessary reliance on management's representations; and his close association with business firms which form the bulk of auditing clients. Even were the auditor capable of such a pure state of independence, it could be considered undesirable.

> Practical independence is what he should aim for--theoretical independence in the "ivory tower" sense would be a disservice to the profession and the economic community. The auditor would be working in a vacuum.[15]

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[14] American Institute of Certified Public Accountants, Code of Professional Ethics (New York: American Institute of Certified Public Accountants, Inc., 1972), p. 8.

[15] T. A. Lee, "The Impact of Company Legislation on the Independence of Auditors," The Accountant's Magazine 72 (July 1968): 366.

Although auditors are not expected to achieve an independence of this nature, the concept should not be considered useless. As Casler noted, "it should be considered as a conceptual ideal, useful as a criterion for the evaluation of the actual practice of public accounting."[16]

> It follows that the concept of independence should not be interpreted so loosely as to permit relationships likely to impair the CPA's integrity or the impartiality of his judgment, nor so strictly as to inhibit the rendering of useful services when the likelihood of such impairment is relatively remote.[17]

A further limitation in the discussion of the guidelines is they concentrate on the auditor's personal efforts to maintain his independence and, while they do consider influencing factors from various sources, are not concerned specifically with the profession's efforts to enhance the image of auditors as a group with respect to independence, or with what Mautz and Sharaf term "profession-independence."[18] Finally, a limitation exists in the sense that the concept of independence, like the other standards and auditing itself, is not static but must change with changes in the auditor's working environment. That is, independence must be interpreted in

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[16]Darwin J. Casler, The Evolution of CPA Ethics: A Profile on Professionalization (East Lansing, Michigan: Michigan State University, 1964), p. 7.

[17]American Institute of Certified Public Accountants, Code of Professional Ethics, p. 8.

[18]R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (Menasha, Wisconsin: George Banta Company, Inc. for the American Accounting Association, 1961), pp. 208-18.

light of changing relationships between the auditor and his client. An example of a changing relationship to be considered in terms of independence is the growing emphasis on public accounting firms supplying management advisory services for audit clients. Interpretations of independence must, as a result of this emphasis, include considerations of possible conflicts of interest between the two services and possible feelings of advocacy toward the client arising from management advisory services.

As one of the general standards of auditing, independence represents a personal quality of the individual. However, the term "individual" must be understood here as including more than a single auditor because the auditing environment is such that one person rarely has authority and responsibility for all phases of an audit.

> The notion of "an independent auditor" for a medium-sized or large public accounting firm is a fiction. This "auditor" is more realistically identified as a public accounting firm. The responsibility for the opinion is a firm responsibility, and the authority for the opinion lies at the top. The signatures on audit opinions, as published in corporate reports, are not signatures of living people with varying "states of mind"; they are stamps of firms with public images.[19]

The assumption is made, then, that the auditor is concerned not only with his own maintenance of independence but also with that of assistants, subordinates,

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[19]Floyd A. Beams and Larry N. Killough, "Audit Independence--An Extension of the Concept," The National Public Accountant 15 (December 1970): 14.

associates, or others on whose work he relies. Other assumptions underlying the concept of independence and its guidelines are that the auditor has a primary responsibility to the public or third parties and that "the primary thrust of the work in which the public accountant is engaged, so far as it involves the expression of opinions on financial statements, is directed at third parties."[20] If the primary area of responsibility were not to the public but instead to the client, independence would not be an issue since the client would be in a position to evaluate objectively views expressed by the auditor, and the auditor would rarely be independent since his continued employment in such a case would depend on his having views compatible with those of the client.[21]

The guidelines extend to both aspects of the auditor's independence identified as independence in fact and in appearance. These aspects are not treated as separate issues but rather are viewed as criteria which the auditor must satisfy. Adherence to the standard requires both be maintained.

In striving for a better understanding of independence, the discussion covers the meaning of the concept in auditing, conditions which adversely affect

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[20] Hill, "The Public Accountants' Legal Liability to Clients and Others," p. 29.

[21] Ibid., pp. 28-29.

independence, indicators of independence, and the process of evaluating or testing independence.

Meaning of Independence

Independence as a descriptive quality of the auditor is used in several senses and has been so described in professional literature and by various writers. Basically, the senses in which independence is applied to auditors are the general meaning implied by the term "self-reliance" which is expected of all professionals,[22] the appearance to the public of independence in relationships between the auditor and client, and lack of bias with respect to the client under audit, or what is termed being "intellectually honest."[23] Of these three senses in which independence is applied to auditors, the first two, self-reliance and appearance, are the most objective, and some specific rules and ideas exist with respect to them. The third sense of the word, intellectual honesty, is the most nebulous and needful of clarification. Therefore, while all these meanings will be discussed, emphasis will be given to the third area.

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[22] Mautz and Sharaf, The Philosophy of Auditing, pp. 205, 231.

[23] American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 8-9.

Appearance of Independence

Independence in appearance means being "free from any obligation to or interest in the client, its management, or its owners;" the avoidance by auditors of "situations that may lead outsiders to doubt their independence."[24] As a test of independence in appearance, the American Institute of Certified Public Accountants

> . . . uses the criterion of whether reasonable men, having knowledge of all the facts and taking into consideration normal strength of character and normal behavior under the circumstances, would conclude that a specified relationship between a CPA and a client poses an unacceptable threat to the CPA's integrity or objectivity.[25]

Using this criterion, various relationships between the auditor and his clients are proscribed. The proscribed relationships include

> (1) certain financial relationships with clients and
> (2) relationships in which a CPA is virtually part of management or an employee under management's control.[26]

A criticism of the criterion is the average or reasonable person rarely will know all the facts so that

> Appearance of independence might better be redefined to assume that judgments will be made <u>without</u> all the facts but on only so much of the facts as the public will be likely to have within our present communications system.[27]

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[24]Ibid., p. 9.

[25]American Institute of Certified Public Accountants, <u>Code of Professional Ethics</u>, p. 9.

[26]Ibid.

[27]L. William Seidman, "The End of the Great Green Eyeshade," <u>The Journal of Accountancy</u> 133 (January 1972): 53.

In specific cases, the "observer's opinion will be based, not on the objective features of a situation, but on the meaning that situation has for him."[28] Another aspect of the appearance of independence is the image of auditors as a group or the public's impression of the profession--an impression which may be transferred to individual auditors.[29]

As mentioned, the American Institute of Certified Public Accountants has proscribed certain relationships between the auditor and client which may lead to impairment of independence. These are incorporated in the profession's rules of conduct and their interpretations,[30] and maintenance of independence in appearance obviously means avoidance of such relationships. The auditor also can look to the Securities and Exchange Commission's interpretations of the concept for further elucidation of independence in appearance in terms of proscribed relationships found in its regulations and decisions published as Accounting Series Releases.[31] These relationships are

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[28]D. R. Carmichael and R. J. Swieringa, "The Compatibility of Auditing Independence and Management Services--An Identification of Issues," The Accounting Review 43 (October 1968): 699.

[29]Mautz and Sharaf, The Philosophy of Auditing, p. 205.

[30]American Institute of Certified Public Accountants, Code of Professional Ethics, pp. 20-21, 32-34.

[31]See Rappaport, SEC Accounting Practice and Procedure, ch. 26; U. S., Securities and Exchange Commission,

brought out more fully in the discussion of conditions which affect the auditor's independence.

Self-reliance of a Professional

Independence, in terms of being self-reliant, means "not subject to control by others: not subordinate . . . self-governing, autonomous, free . . . not requiring or relying on someone else . . . not looking to others for one's opinions or for the guidance of one's conduct."[32] For the auditor, self-reliance means not subordinating professional judgments and opinions nor shifting responsibility for such judgments or opinions to anyone else including clients, government agencies, creditors, other users of financial statements, or even superiors within the audit firm.[33] This self-reliance meaning of independence distinguishes the professional from the skilled craftsman.[34]

Accounting Series Releases--Compilation of Releases 1 to 112 Inclusive, Releases Nos. 47, 81, 112 (1968), pp. 60-64, 196-203, 297-98; and U. S., Securities and Exchange Commission, Independence of Accountants--Guidelines and Examples of Situations Involving the Independence of Accountants, Accounting Series Releases, Release No. 126 (1972).

[32] Webster's Third New International Dictionary, s.v. "independent."

[33] John L. Carey and William O. Doherty, Ethical Standards of the Accounting Profession (New York: American Institute of Certified Public Accountants, Inc., 1966), p. 18.

[34] Mautz and Sharaf, The Philosophy of Auditing, p. 231.

Intellectual Honesty

Traditional Descriptions

While independence in appearance and self-reliance are relevant to the concept of independence, the meaning of independence in fact as intellectual honesty is the unique or special meaning attached to the concept as applied to professional auditors. It relates specifically to the auditor's state of mind as he performs the audit examination and reports the results of his findings including his opinion regarding the statements under audit. This frame of mind has been defined by the profession as "without bias with respect to the client under audit," as "a judicial impartiality that recognizes an obligation for fairness" to those who rely on the auditor's report, and as "a matter of personal quality."[35] Various writers similarly have commented on this aspect of independence, referring to it as "obedience to the dictates of a scrupulous conscience," as precluding bias in favor of or against clients under audit,[36] as "that characteristic of the practicing professional which enjoins him from

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[35]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 8-9.

[36]E. A. Kracke, "Auditing Standards: The Personal Standards of the Auditor," The New York Certified Public Accountant 16 (December 1946): 680-81.

engaging in rationalization,"[37] and as "freedom from the control or influence of those whose work is being reviewed."[38] Synonyms for independence also hint of this "intellectual honesty" aspect of the standard, for example, the terms indifferent, disinterested, and integrity. Indifferent means "marked by no special liking for or dislike of something;" "objectivity, freedom from personal interests, especially financial, and impartiality."[39] Disinterested is defined as "not influenced by regard to personal advantage: free from selfish motive."[40] Integrity perhaps comes nearer the intent behind intellectual honesty in its definition as "an uncompromising adherence to a code of moral, artistic, or other values;" "utter sincerity, honesty, and candor;" "avoidance of deception, expediency, artificiality or shallowness of any kind."[41]

The traditional descriptions of independence are superficial in nature, characterizing qualities of intellectual honesty but not getting at the core of its meaning or explaining how it can be achieved. To explain more

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[37] Robert M. Trueblood, "The Management Service Function in Public Accounting," The Journal of Accountancy 112 (July 1961): 42.

[38] Casler, The Evolution of CPA Ethics: A Profile on Professionalization, p. 7.

[39] Webster's Third New International Dictionary, s.v. "indifferent."

[40] Ibid., s.v. "disinterested."

[41] Ibid., s.v. "integrity."

fully the concept of independence as intellectual honesty, an expanded description based on related philosophical ideas is offered. Following that description are discussions of the conditions which affect independence, indicators of it, and the process of evaluating its maintenance.

An Expanded Description

The expanded description of the meaning of intellectual honesty includes ideas on remaining free of self-deception regarding the state of mind and on cultivating attitudes which promote intellectual honesty. Self-deception may be viewed as the opposite of intellectual honesty or as preventing its maintenance. It has been described by Herbert Fingarette in his book, Self-Deception.[42] Following is a synopsis of his explanation of the self-deceiver including motives for self-deception, the means to avoid self-deception, and the options available to the person moving into a situation of self-deception.

Basically, the self-deceiver is described as an individual engaged in the world in some way but who disavows his engagement, refusing to acknowledge it as his or to accept responsibility for it. His rejection of the engagement is authentic, not merely irresponsible shirking

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[42] Herbert Fingarette, Self-Deception (New York: Humanities Press, Inc., 1969).

of personal responsibilities, and occurs while he actually is pursuing the very engagement he disavows.[43] "Engagement" covers what one does or understands, including, for example, aims, reasons, motives, attitudes, action, conduct, and perceptions.[44] The self-deceiver can be explained, as is done in the following example, through comparison with the insincere person, ordinary liar, the irresponsible person, and the truly sincere or explicitly conscious person. The comparison is based on three criteria or characteristics of sincerity.

> More formally, the criteria are:
>
> (1) It is not the case that there is an intentional difference in the way the individual spells his engagement out to others and the way he spells it out to himself;
>
> (2) The way he spells the engagement out to himself reflects the engagement correctly and aptly.
>
> (3) He has not been unintentionally wrong in the way he came to express the engagement.
>
> If (1) does not hold, the person is not sincere. . . . If (1) does not hold but (2) does, we have ordinary lies, deceit, trickery. . . . If (1) and (2) hold, but not (3), we have the 'shallow' sincerity of the irresponsibly erratic or impetuous person. . . . If both (1) and (3) hold, then we normally characterize the person as sincere--since it is normally the case that (2) also holds. To say that (2) normally holds is, in effect, to say that normally a person tells himself the truth about his engagement.
>
> The odd, but not so rare, case comes when (2) does not hold but (1) and (3) do. . . . Since he gives himself the very same story he gives us, we initially characterize him as sincere. Yet the more we observe him, the more we are convinced that something is abnormal, unusual, wrong; we come to see that the story he is telling both himself and us is not

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[43] Ibid., pp. 66-67, 140-41.

[44] Ibid., pp. 37-41.

> unintentionally wrong but purposely wrong. We now ascribe to him a peculiar, 'deeper' insincerity. . . . The more we do appreciate that (2) does not hold in a particular case, the more we see the person as a deceiver.[45]

The self-deceiver, then, purposely does not tell himself the truth about his engagement and appears at first glance to be sincere. His self-deception goes deeper than simple lying or hypocrisy.

The motives behind self-deception include lack of self-control or self-discipline, but they have their roots in factors giving rise to the need for self-deception. These factors are the individual's characteristics of integrity--high morals or ethics and principles, a sense of being highly responsible for one's engagements, and deep concern for one's integrity--combined with a powerful inclination toward an engagement incompatible with his integrity. In other words, the motive behind self-deception is movement into a morally ambiguous engagement.[46] The person of great integrity and a deep sense of personal responsibility who is provoked into an engagement conflicting with his integrity disavows the engagement--that is, enters into self-deception--

> . . . for to avow it would apparently lead to such intensely disruptive, distressing consequences as to be unmanageably destructive to the person. The crux of the matter here is the unacceptability of the engagement to the person. The individual may be

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[45]Ibid., pp. 52-54.

[46]Ibid., pp. 87, 136-50.

> powerfully inclined towards a particular engagement, yet this particular engagement may be utterly incompatible with [what he accepts as himself].[47]

The person who does not have high morals, a deep concern for his integrity, or a sense of personal responsibility does not have the same need for self-deception; without integrity, his engagements are not morally ambiguous or incompatible to him.

> The person who cares deeply is, on the other hand, the one most tempted to disavow an engagement because of the burdens he not only foresees, but of his own free will would accept should he avow the engagement.[48]

The self-deceiver does not lack concern or integrity "but some combination of courage and a way of seeing how to approach his dilemma without probable disaster to himself."[49] The greater the individual's integrity and concern and the more powerful the conflicting inclinations or pressures, the greater is the temptation or need for self-deception.

In relating these ideas of the self-deceiver to the auditor, his position is analogous to that of the person most tempted to enter into self-deception. By holding himself out as a professional auditor, he is held to a high degree of personal responsibility to an unseen audience, the public; to certain standards, principles, and

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[47] Ibid., p. 87.

[48] Ibid., p. 148.

[49] Ibid., p. 143.

ethics regarding his conduct or engagements in the world of auditing; to concern for his integrity. In addition, the nature of his profession is such that he faces pressures from numerous sources which, if not recognized and checked, would impair his independence by drawing him toward ethically unacceptable or morally aibiguous activities.

The means for an individual's avoiding self-deception or, conversely, maintaining intellectual honesty, is his becoming and remaining explicitly conscious of his engagements. This is accomplished by exercising the specific skill of spelling out engagements--clearly assessing the situation, singling out what is relevant, and giving explicit expression to the engagement in a language-like form. The term "spelling out" is used in a colloquial sense of making something explicit in a clearly and fully elaborated way, not in a literal sense of writing down or saying aloud the features of an engagement. The skill is learned; it is an ability or capacity within a person shaped and sharpened by training and experience under the supervision of more experienced people. Spelling out or becoming explicitly conscious of one's engagements requires going to great lengths with respect to the engagement. It therefore is not applied generally to every possible engagement but only selectively to specific ones in which adequate need exists for the person's being explicitly conscious of his conduct. Rather than take explicit consciousness for granted, its absence must be assumed, and it should be viewed as "the further exercise of a specific skill for special reason."[50] The auditor intent on maintaining an independent state of mind must exercise this skill of spelling out his engagements in order to become explicitly conscious of them. Furthermore, he must selectively apply the skill to those situations relevant to independence. Spelling out an engagement includes assessing the audit situation in terms of factors which influence independence, singling out those factors relevant to the auditor and his state of mind, and giving explicit expression in a clearly and fully elaborated way to the actual influences on the mind. If the skill is not exercised in situations where need exists for it, the auditor is in danger of entering into self-deception regarding his independence. In fact, the case for self-deception is described in terms of not spelling out such situations.

> . . . here we come to the case of most direct interest for self-deception. This is the situation in which there is overriding reason <u>not</u> to spell-out some engagement, where we skillfully take account of this and systematically avoid spelling-out the engagement, and where, in turn, we refrain from spelling-out this exercise of our skill in spelling-out. In other words, we avoid becoming explicitly conscious of our engagement, and we avoid becoming explicitly conscious that we are avoiding it.[51]

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[50] Ibid., pp. 38-42.

[51] Ibid., p. 43.

Furthermore, the self-deceiver does not stop at the avoidance of spelling out his engagements.

> He is forced to fabricate stories in order to keep his explicit account of things and the way things really are in some kind of harmony such as will make his account of things plausible. However, he does not spell-out that he is doing this. That is, it continues to be the case that the fabrications he tells us he also tells himself.[52]

To be intellectually honest, the auditor must not deceive himself concerning his engagements, and he achieves that goal by exercising the skill of spelling out his engagements such that he is explicitly conscious of what he is doing. The ideal in being explicitly conscious or intellectually honest is one found in Christian, Jewish, and even mystical traditions and expressed as

> . . . the perfect virtue of a person who does the right and the good not through obedience to the Law and self-discipline, but as the issue of his spontaneous response to the situation and the moment. . . . Another way to express the same ideal is to speak of a person who accepts himself totally, an individual who freely, spontaneously, does what in fact is always an expression of his personal integrity.[53]

The individual who finds himself strongly inclined toward a form of engagement inconsistent with his governing principles--the type of situation most likely to lead to self-deception or loss of independence--has three options.

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[52]Ibid., p. 62.

[53]Ibid., p. 97.

> One option under such circumstances is for the individual to forego the engagement, or to abandon it if he has already entered upon it in some degree. Normally, this is the chosen option of the adult person. . . .
>
> A second option is to pursue the engagement, the person avowing it as his. To do this would be for the person to face a spiritual crisis [that is, to be in a morally ambiguous position]. . . .
>
> If there is a stalemate between inclinations which the individual will not give up, and the refusal by the person to avow these inclinations as his, there then remains one last option: the individual does engage himself in the way to which he is inclined, but the person refuses to acknowledge the engagement as his. . . . It is from this perspective, . . . that we see how someone, by reason of lack of spiritual courage, attempts to save his integrity at a price which amounts to surrendering, however indirectly, the very integrity he cherishes.[54]

Relating these options to the auditor, the first is that demanded by the standard of independence and normally associated with the professionally mature auditor. If the auditor concludes he is not independent, he is not qualified to express an opinion. If he is not associated with the financial statements, he must forego the engagement by refusing to become associated with the financial statements and by withdrawing completely from the engagement. If he is associated with the statements, he must disclaim an opinion.[55] The second option is an overt disregard of independence akin to irresponsibility. That is, the auditor would continue with an engagement in which

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[54]Ibid., pp. 138-39.

[55]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 92-93.

he knows he is not independent. The third option is lack of intellectual honesty, or self-deception. Under this option, the auditor would undertake an audit engagement in which he is not independent, but he would refuse to acknowledge his lack of independence.

Complementing the meaning of intellectual honesty as avoidance of self-deception is its meaning in terms of the cultivation of various attitudes. These attitudes have been labeled open-mindedness, wholeheartedness, and responsibility.[56] In effect, they prevent the operation of defense mechanisms which lead to self-deception. These defense mechanisms are discussed as conditions adversely affecting independence. Open-mindedness means freedom from bias or partisanship, but in addition it means a positive willingness to consider new ideas.

> It includes an active desire to listen to more sides than one; to give heed to facts from whatever source they come; to give full attention to alternative possibilities; to recognize the possibility of error even in the beliefs that are dearest to us.[57]

The essence of open-mindedness is "alert curiosity and spontaneous outreaching for the new."[58] Whole-heartedness refers to undivided interest in the situation at hand--an attitude of enthusiasm rather than perfunctory

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[56]John Dewey, How We Think (Boston: D. C. Heath and Company, 1933), pp. 30-33.

[57]Ibid., p. 30.

[58]Ibid., p. 31.

attention.[59] It may be viewed as the dominance of form over substance in auditing. Responsibility is the attitude of thoroughness--of considering, weighing, and adopting the consequences which reasonably follow from positions or beliefs taken.[60]

In summary, the meaning of intellectual honesty includes traditional descriptions centering on freedom from bias with respect to the audit client, the avoidance of self-deception through being explicitly conscious of engagements, and the cultivation of attitudes which prevent falling into biases that destroy independence and which prevent the use of defense mechanisms that lead to self-deception. Intellectual honesty is the heart of the independence concept in auditing and is stressed in the remaining discussions.

Conditions Adverse to Independence

Adherence to the standard of independence demands an auditing environment in which it can exist. Therefore, conditions which are adverse to independence should not be allowed in that environment. These conditions represent possible impairments to the auditor's independence and consist of "pressures and factors, some of which may be

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

[60] Ibid., pp. 32-33.

so subtle as to be scarcely recognizable, which may color or influence his disinterestedness."[61] They may emanate from the individual auditor himself, from the public accounting firm with which he is associated, from his clients, and from the accounting profession. The auditor may or may not have direct control over the existence of many of these conditions, but he must, to be independent, exercise control over their possible adverse effects on his state of mind and on his appearance of independence.

Because many of these conditions have been discussed at length in auditing literature, their treatment here is in the nature of a summary with references to fuller descriptions. An exception to this treatment is the discussion of mental attitudes the individual may possess--attitudes which would lead to self-deception if unchecked.

Conditions Emanating From the Individual

Conditions emanating from the individual and having possible adverse effects on his independence relate to his personal views or situation. Basically, they consist of preconceived ideas or biases; attitudes in the nature of defense mechanisms; and financial, family, or employee relationships with the client. The latter refer to relationships proscribed by the auditing profession and having their main impact on the appearance of independence.

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[61] Mautz and Sharaf, The Philosophy of Auditing, p. 206.

An auditor could, in other words, enter into these relationships without adversely affecting his independence in fact, but the very reason for their proscription is recognition of the difficulty in remaining impartial under such conditions. They therefore should be viewed as conditions having possible adverse effects on independence in fact and definite adverse effects on independence in appearance.

Preconceived Ideas and Biases

Preconceived ideas and biases may be in favor of or against the client and directed at operations, the audit itself, individuals, or groups of people.[62] Examples include fixed ideas concerning accounting methods, principles, and systems; the attitude during the audit of either a prosecutor against or advocate for the client; the supposition that a respected and successful businessman is incapable of error or deception; and feelings of loyalty to or identification with certain groups. A description of how the auditor acquires such biases is given in the following account.

> As a successful accountant the auditor tends to identify with the "officer corps". He probably has close business and social contact with directors. If not already a public company director himself, he probably aspires to become one; he may see his auditing appointments as a means to that end. Even more

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[62]U. S., Comptroller General, Standards for Audit of Governmental Organizations, Programs, Activities & Functions (1972), p. 16.

> to the point, he depends in fact, though not in law upon promoters' and directors' favours for his present and future auditing appointments. His auditing prospects, and those of his practice generally, will not be enhanced if he is more "difficult" than conventional auditors.[63]

These preconceived ideas prevent the auditor's being mentally receptive to any other ideas, facts, or beliefs which may be relevant to the situation. Effectively, he becomes subservient to or dependent on them, his mind is closed to any other channels of thinking, and independent judgment cannot be exercised.

Attitudes in the Form of Defense Mechanisms

The existence of various mental attitudes including those termed defense mechanisms can be considered as conditions adversely affecting independence in the same way biases are so considered. They prevent intellectual honesty, leading instead to self-deception regarding judgments made. These attitudes lead the auditor to see what he wants to see or single out that which supports his own beliefs.

Defense mechanisms are defined as adjustive reactions employed to protect against anxiety, guilt, or loss of self-esteem.[64]

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[63] John R. Forbes, "A Fiduciary Watchdog? Auditors' Conflicts of Interest," The Chartered Accountant in Australia 40 (March 1970): 10.

[64] Robert M. Goldenson, The Encyclopedia of Human Behavior, 2 vols. (Garden City, New York: Doubleday & Company, Inc., 1970), 1: 300.

> Among the most common types are refusal to admit the truth (denial of reality), escape into a satisfying world of fantasy . . ., giving false but socially approved reasons to justify questionable behavior (rationalization), blaming others for personal shortcomings or attributing to others our own unacceptable impulses or desires (projection), excluding painful or dangerous thoughts . . . (repression), gaining sympathy . . . (regression), denying faulty impulses by going to the opposite extreme (reaction formation), avoiding hurt through apathy or detachment (emotional insulation), and increasing feelings of worth by identifying with important people or institutions (identification).[65]

These mechanisms are based on natural or normal tendencies and may, in some cases, have beneficial effects, but when they lead to escapes from problems and reality, they result in self-deception. Behavior involving these mechanisms is, or should be, viewed as defensive based on such indicators as the intensity of the reactions, overemphatic protestations, and going to extremes in the direction of these responses.[66]

Some defense mechanisms particularly applicable to audit situations and against which the auditor should guard in maintaining independence are grouped for discussion purposes as follows: (1) rationalization, intellectualization, and dissociation; (2) compensation, repression, suppression, and substitution; (3) flight into reality; (4) identification, introjection, and idealization; and (5) undoing.

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[65]Ibid., p. 300.

[66]Ibid., 1: 300-301.

Rationalization means "giving questionable reasons to justify behavior or relieve disappointment," and it is applied usually to behavior which is itself unacceptable or dubious.[67]

> Rationalization is used as a cover-up for mistakes, misjudgments, and failures. It tries to justify behavior by reasons that are made to sound rational.[68]

Signs of rationalization other than justification of questionable behavior are finding reasons to take the place of those which fall short of the justification, giving faulty reasons more weight and attention than they merit, defending faulty reasons with undue emotional intensity, and refusal to correct mistakes.[69] Intellectualization, in some respects, is similar to rationalization. With this defense mechanism, problems are analyzed in purely intellectual terms without consideration or acknowledgment of their emotional or personal effects.[70] The auditor could employ intellectualization to analyze away a personal bias--one not apparent to others and not affecting independence in appearance--as really not affecting his state of mind when in fact it does. Dissociation is described

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[67] Ibid., 2: 1094-95.

[68] Benjamin B. Wolman, ed., Dictionary of Behavioral Science (New York: Van Nostrand Reinhold Company, 1973), p. 313.

[69] Goldenson, The Encyclopedia of Human Behavior, 2: 1095.

[70] Ibid., 1: 623-24.

in the phrase "not letting the left hand know what the right hand is doing," and it results in an inconsistency between what is professed and actually practiced. It is a lack of awareness or self-deception allowing engagement in a morally ambiguous activity while maintaining a sense of integrity, and it may be bolstered by use of other defenses such as rationalization.[71]

The second group of defense mechanisms leads to avoidance of admitting or acknowledging unpleasantries, failings, or unacceptable conduct. Compensation is a means of covering up unacceptable aspects by stressing more desirable traits.[72] Repression is an evasion of problems by refusal to think of them. Generally, it is viewed as an unconscious mechanism whereas suppression is seen as a deliberate refusal to deal with problems. Substitution refers to accepting alternatives when desired goals cannot be attained. An example is dwelling on past accomplishments instead of or as a substitute for admitting failures. Like the first group of defenses, these lead to self-deception or a putting off of problems. In auditing, these defenses would lead the auditor to refuse

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[71]See Goldenson, The Encyclopedia of Human Behavior, 1: 339-40; and Wolman, Dictionary of Behavioral Science, p. 103.

[72]See Goldenson, The Encyclopedia of Human Behavior, 1: 239, 2: 1129-30, 1272, 1282-83; and Wolman, Dictionary of Behavioral Science, pp. 70, 323, 362.

acknowledgment of a lack of independence or to failure in properly or promptly handling a lack of independence.

Flight into reality is a means of escaping unpleasant thoughts by overinvolvement in activity which likely is trivial or inflated in importance.[73] An auditor attempting to avoid recognition of a lack of independence or of conditions adversely affecting independence may escape consideration of them by giving undue attention to other aspects of the audit. His independence would be threatened by his refusal to meet the problems relevant to it.

Identification and introjection are tendencies to adopt the attitudes or behavior of others.[74] In the case of auditors, they could lead to identification with management groups and to reinforcement of feelings of advocacy toward clients. In the process of identifying with others, the defense mechanism of idealization--"overestimating the character or abilities of another person"[75] --may be employed. The use of this defense would be detrimental to independence, for example, if the auditor were to overestimate the character or abilities of those whose work he is auditing and fail to take proper

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[73]Goldenson, The Encyclopedia of Human Behavior, 1: 467.

[74]Ibid., 1: 590-91, 640.

[75]Ibid., 1: 590.

precautions in checking their work or if he were to always accept authority without question.

Undoing is a defense mechanism employed to nullify previous actions such as past blunders with ethical ones rather than admitting and accepting responsibility for them. It results in a "patent distortion of truth."[76] The auditor aware of his previous mistakes but who attempts to nullify them with proper behavior in other areas rather than admit them risks loss of independence through having to continue means of covering up those mistakes or through having to suppress knowledge of improper actions on the part of others--knowledge which also could uncover his shortcomings.

Defense mechanisms are natural tendencies which, if allowed to become exaggerated, result in conditions adverse to maintenance of an independent state of mind in that they prevent the auditor's acknowledging that state for what it really is. Below is an example of a failure to maintain independence. Existence of several of the defense mechanisms may be implied in the actions of the auditors.

Example of a Loss of Independence in Fact

The example used to illustrate a loss of independence in fact is the legal case called the Continental

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[76] Wolman, Dictionary of Behavioral Science, p. 398.

Vending case in which three auditors were found to have certified financial statements known to contain false and misleading information. The facts of the case with its implications of failure to maintain independence follow.[77]

The trial concerned financial statements of Continental Vending Machine Corporation for the year 1962 which were certified by three auditors of Lybrand, Ross Bros. & Montgomery--Simon, Kaiser, and Fishman. Of particular concern were transactions between Continental Vending Machine Corporation, its affiliate Valley Commercial Corporation, and Harold Roth who was president of Continental and supervisor of Valley's operations. The transactions involved loans, beginning as early as 1956, from Valley to Continental, from Continental to Valley, and from Valley to Roth who used the cash in his personal stock market transactions.

By the end of 1962, loans from Continental to Valley exceeded $3.5 million, approximately the same amount loaned to Roth by Valley. This figure was more than double that of the prior two years. Also at the end of 1962, Roth was unable to repay his loans to Valley, and Valley consequently could not repay its loans from Continental. Roth posted as collateral for his debt to Valley and its obligation to Continental securities 80% of which consisted of stock in Continental.

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[77]United States v. Simon, 425 F. 2d 796 (2d Cir. 1969).

The auditors admitted knowledge of the facts before the certification date--one since 1958 and one since 1960. They had reason to believe that the company was, to a material extent, being operated for the benefit of its president rather than shareholders and that the president was dishonest in looting and diverting company funds. Despite their knowledge, disclosure was made neither of the loans to Roth nor of the make-up of the collateral. The footnote explanation in the financial statements was carefully designed instead to conceal the facts. The auditors did insist, however, on financial statements dismal in other respects, but rather than prove their innocence, the comment was made that "men who find themselves in a bad situation of their own making do not always act with full rationality."[78]

The auditors' motive for concealing the facts was found not to be the usual commercial ones in fraud cases since none of the auditors personally stood to gain financially, since the Lybrand firm would not risk losing a valuable account, and since the Continental account personally was not important to the auditors. Rather, motive was found to be the auditors'

> . . . desire to preserve Lybrand's reputation and conceal the alleged dereliction of their predecessors and themselves in former years--the failure to advise Continental's board of directors of Roth's role in creating the Valley receivable . . .; the failure to

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[78]Ibid., p. 809.

> expand the scope of the audit for those years to determine the nature and collectibility of the Valley receivable, despite the injunction in a well-known text originally authored by one of the founders of the Lybrand firm, that receivables from affiliates must be scrutinized carefully to determine they "are what they purport to be"; and the certification of the 1961 statements despite Simon's warning to Roth that a further increase in the receivable would necessitate an examination of Valley's books.[79]

This deduction regarding motive describes the loss of independence in fact through the auditors' failure to acknowledge their mistakes. Furthermore, they took definite steps to conceal them through deliberately designed statements which they justified on the basis that generally accepted accounting principles did not require disclosure of the facts. However, the court's statements indicate disclosure is required in circumstances of looting, dishonesty, a corporation being operated to a material extent for its president, and diversion of funds.[80] These were the real circumstances of the case not those merely, as the auditors claimed, of loans to an affiliate.

Auditor/Client Relationships

In addition to preconceived ideas, biases, and attitudes, other conditions emanating from the individual

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[79] Ibid., pp. 808-809.

[80] See David B. Isbell, "The Continental Vending Case: Lessons for the Profession," The Journal of Accountancy 130 (August 1970): 37; and United States v. Simon, 425 F. 2d 806 (2d Cir. 1969).

and adversely affecting independence are relationships between the auditor and client due to the auditor's personal situation. They fall into four basic categories.

1. Relationships of an official, professional, and/or personal nature that might cause the auditor to limit the extent or character of his inquiry, to limit disclosure, or to weaken his findings in any way.[81]

These relationships result in adverse effects on independence in situations in which the auditor has not remained free of the client's influence during the audit. Examples of such situations are those in which the auditor essentially is part of management or an employee under control of management as could be the case in his acting as promoter, trustee, officer, or director directly for the client or indirectly through an organization having control over the client; those in which former audit firm members still associated in some way with the firm also become associated with a client; those in which a confidential relationship exists between the auditor and client; those in which the auditor has direct dealings only with the management of the client; those in which the auditor, in addition to his audit activities, has outside business relationships with the client; those in which the auditor's connections in other capacities affect the client's business; and those in which the auditor has

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[81]U. S., Comptroller General, Standards for Audit of Governmental Organizations, Programs, Activities & Functions (1973), p. 16.

close relationships to a client through his family or through other personal interests.[82]

> 2. Previous involvement in a decisionmaking or management capacity in the operations of the . . . entity . . . being audited.[83]

Previous involvement refers to circumstances in which the auditor has worked closely with the client's management and from which may arise feelings of advocacy toward the client, a mutuality of interest with the client, the appearance of his serving two masters at the same time, the auditor's essentially auditing his own work, logical and emotional involvement with management, engagement in incompatible occupations, or to the auditor's having a stake in the client's business.[84]

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[82]See American Institute of Certified Public Accountants, Code of Professional Ethics, pp. 9, 21, 23, 32-33, 36; American Institute of Certified Public Accountants, Division of Professional Ethics, Summaries of Ethics Rulings (New York: American Institute of Certified Public Accountants, Inc., 1970), pp. 2-20, 25, 30-31, 37-48; Richard S. Helstein, "Privileged Communications for CPAs," The Journal of Accountancy 131 (December 1970): 39-46; Mautz and Sharaf, The Philosophy of Auditing, pp. 211-12; and Rappaport, SEC Accounting Practice and Procedure, pp. 26.22-23, 35-40, 44, 48-49, 50-55.

[83]U. S., Comptroller General, Standards for Audit of Governmental Organizations, Programs, Activities & Functions (1973), p. 16.

[84]See American Institute of Certified Public Accountants, Summaries of Ethics Rulings, pp. 5, 13-14; "Auditors' Responsibility to Disclose Information Obtained Subsequent to Publication of Opinion on Financial Statements," The Journal of Accountancy 124 (July 1967): 56-60; Carmichael and Swieringa, "The Compatibility of Auditing Independence and Management Services--An Identification of Issues;" Stephen E. Loeb, "Incompatible Occupations for CPAs--An Inquiry Into Compliance," The New York

3. Actual or potential restrictive influence when the auditor performs preaudit work and subsequently performs a post audit.[85]

This condition tends to result in the auditor's auditing his own work. In general, it covers those circumstances of the auditor's providing accounting services or services related to the accounting for audit clients.[86]

4. Financial interest, direct or indirect, in an organization or facility which is benefiting from the audited programs.[87]

For audits of public firms, this condition refers to financial interest in the client under audit, and it covers varied means leading to such an interest. For example, commitments to acquire an interest, joint

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Certified Public Accountant 41 (June 1971): 433-37; Mautz and Sharaf, The Philosophy of Auditing, pp. 221-24; Arthur A. Schulte, Jr., "Management Services: A Challenge to Audit Independence?" The Accounting Review 41 (October 1966): 721-28; Arthur A. Schulte, Jr., Frank J. Hoenemeyer, and Malcolm M. Devore, "Compatibility of Auditing and Management Services," The Journal of Accountancy 124 (December 1967): 29-39; Pierre L. Titard, "Independence and MAS--Opinions of Financial Statement Users," The Journal of Accountancy 132 (July 1971): 47-52; and John V. Van Pelt III, "Tax Practice and Auditing," The Journal of Accountancy 133 (May 1972): 33.

[85]U. S., Comptroller General, Standards for Audit of Governmental Organizations, Programs, Activities & Functions (1973), p. 16.

[86]See American Institute of Certified Public Accountants, Code of Professional Ethics, pp. 33-34; and American Institute of Certified Public Accountants, Summaries of Ethics Rulings, pp. 1, 5, 12-13, 30.

[87]U. S., Comptroller General, Standards for Audit of Governmental Organizations, Programs, Activities & Functions (1973), p. 16.

investments, loans, contingent fees, and even the audit fees received from clients would be included in this category.[88]

Conditions Emanating From the Audit Client

Conditions adverse to independence and emanating from the audit client refer to restrictions on the auditor's investigation and reporting. The existence of these restrictions affect his ability to draw conclusions or form judgments necessary for rendering an opinion. Examples of these conditions include the following.[89]

1. Interference or other influence that improperly or imprudently eliminates, restricts, or modifies the scope or character of the audit.

This condition refers to attempts, in particular by the management of the client, to subject the audit to review other than that provided in the audit process.[90] It may be brought about or strengthened through the auditor's

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[88]See American Accounting Association, "Report of the Committee on Basic Auditing Concepts," p. 46; American Institute of Certified Public Accountants, Code of Professional Ethics, pp. 20-21; American Institute of Certified Public Accountants, Summaries of Ethics Rulings, pp. 1, 20-37, 49-52; Casler, The Evolution of CPA Ethics: A Profile on Professionalization, pp. 15-20, 28-38; Lee, "The Impact of Company Legislation on the Independence of Auditors," pp. 363-67; Mautz and Sharaf, The Philosophy of Auditing, p. 211; and Rappaport, SEC Accounting Practice and Procedure, pp. 26.20-21, 28-35, 44-46.

[89]U. S., Comptroller General, Standards for Audit of Governmental Organizations, Programs, Activities & Functions, pp. 16-17.

[90]Mautz and Sharaf, The Philosophy of Auditing, p. 207.

entering into entangling affiliations with the client, for example, into indemnity agreements which in effect remove the brunt of the auditor's responsibility to third parties.[91]

> 2. Interference with the selection or application of audit procedures or the selection of activities to be examined.

This type of interference refers to client imposed restrictions on the character or extent of the auditor's examination and program planning, and it is considered "a concrete infringement on the auditor's independence."[92] The interference may come through client attempts to determine the activities to be examined or audit procedures to be used, through a client's effectively closing sources of information to the auditor, and through a generally uncooperative attitude on the part of the client.[93]

> 3. Denial of access to such sources of information as books, records, and supporting documents or denial of opportunity to obtain explanations by officials and employees of the . . . organization, program, or activity under audit.

Denial of access to necessary information also would include a lack of direct and free access to

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[91]Rappaport, SEC Accounting Practice and Procedure, pp. 26.51-52.

[92]D. R. Carmichael, "Client Imposed Restrictions on Scope," The Journal of Accountancy 132 (August 1971): 70-71.

[93]Mautz and Sharaf, The Philosophy of Auditing, pp. 206-207.

such information in addition to an outright refusal.[94]

4. Interference in the assignment of personnel to the audit task.

5. . . . restrictions placed on funds or other resources dedicated to the audit operation.

These conditions have a potentially adverse effect on independence because they, in effect, restrict the auditor's freedom to "extend or limit his tests as required to discharge his responsibility."[95]

6. Activity to overrule or significantly influence the auditor's judgment as to the appropriate content of the audit report.

Activity of this type could be in the form of attempts to have matters excluded from the formal report and, instead, included in an informal report, to use ambiguous language in the report, to subordinate the auditor's judgment to the client's desires, to force or encourage reliance on unverified information--especially too heavy a reliance on unverified management representations, to influence disclosure, and to influence financial presentation, particularly where pressure exists to improve earnings per share or in cases of disagreement between the auditor and client as to what constitutes proper financial disclosure.[96]

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[94] Ibid., p. 207.

[95] Casler, The Evolution of CPA Ethics: A Profile on Professionalization, p. 105.

[96] See A. Beedle, "Atlantic Acceptance Corporation--A

7. Influences that place the auditor's continued employment in jeopardy for reasons other than competency or the need for audit services.

Conditions in this category include such pressures as those from the auditor's being economically dependent on clients for his revenues, especially if those clients are few in number and large in relation to the audit firm; threats and the client's power to change auditors when the two disagree; and efforts by clients to pit one auditor against another, particularly in disputes over accounting principles or proper financial presentation.[97]

8. Unreasonable restrictions on the time allowed to competently complete an audit assignment.

Conditions Within the Audit Firm

Conditions within a public accounting firm which adversely affect independence are due to what has been called lack of organizational neutrality. Such conditions include those given below:[98]

1. the auditor's dependence on the firm for assignments, income, prestige, and advancement

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Sorry Affair," The Journal of Accountancy 132 (August 1971): 63-67; Lee, "The Impact of Company Legislation on the Independence of Auditors," p. 364; Mautz and Sharaf, The Philosophy of Auditing, p. 207; Rappaport, SEC Accounting Practice and Procedure, pp. 26.46-48; and A. R. Wyatt, "Competence and Independence in Auditing," The Journal of Accountancy 133 (April 1972): 72.

[97] "Needham of SEC Cautions Profession on Independence," The Journal of Accountancy 132 (May 1971): 9.

[98] Beams and Killough, "Audit Independence--An Extension of the Concept," pp. 17-19.

opportunities, and his consequently being discouraged from independence of the firm;

2. ultimate responsibility and final authority for the firm's activities lying with its partners rather than with auditors in charge of engagements, which means the partners determine independence and audit opinions since they can override decisions made at lower levels and can revise and do sign opinions written by other auditors;

3. the firm's engagement in nonaudit activities which entangle the firm and clients in nonaudit relationships may influence firm policies in the audit area, lead to financial dependence on clients with a corresponding desire to please them in all areas, and lead to a mobility of employees within various service areas;

4. the budgeting of audit hours by the firm's management and subsequent evaluation of the auditor in charge of engagements on the basis of such budgeting;

5. the assignment of inexperienced or insufficiently experienced auditors to be in charge of field work.

Conditions Within the Auditing Profession

Conditions within the auditing profession which may have an adverse effect on independence are due to the auditor's identification with a group, to his relationships with other professional auditors and public accounting firms, and to the impact of other institutions on the profession.

As pointed out by Stettler, the auditing profession has a collective social responsibility for adopting the principles and procedures necessary for fairly presented financial statements, and independence of any particular group--particularly management groups--is necessary for discharging this responsibility.[99]

The auditor's identification with the profession as a group means his independence may be viewed by outsiders in terms of their impression of the independence of auditors as a group. Therefore, any conditions within the profession causing others to doubt the independence of auditors in general would reflect on individual auditors associated with it. As discussed in The Philosophy of Auditing such conditions include the close association of auditing with business due to the financial dependence of auditing firms on business, the existence of confidential relationships between them, and the emphasis of audit firms on being of service to management. Other conditions related to the organization of the profession include its tendency toward a limited number of large firms which, because of their size, must rely on the work of employees who may not project a professional image; by lack of professional solidarity or support of one auditor by another; and by the tendency toward salesmanship in the offering of

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[99]Howard F. Stettler, Systems Based Independent Audits (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1967), p. 84.

services.[100] These conditions may lead to the auditor's being responsible for the work and independence of more employees and to his being pressured to please clients. In addition to these conditions, the auditor's membership in it may lead to another adverse effect on independence. This effect derives from the existence of generally accepted auditing and accounting standards, principles, practices, and procedures which the auditor may be or feel forced or pressured to accept and from the existence of alternative acceptable principles which may be a basis of interfirm competition for clients or the practice by clients of shopping around for auditors.[101] In this same vein, association with the profession causes the auditor to be subject to another condition which could adversely affect independence. This condition relates to efforts on the part of outside institutions such as governmental agencies and law to dictate accounting or auditing policies.[102]

Conclusions and Summary of Conditions

Conditions which adversely affect independence and which, therefore, should not be allowed to interfere with it stem from the individual auditor himself and from

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[100]Mautz and Sharaf, The Philosophy of Auditing, pp. 208-30.

[101]Beams and Killough, "Audit Independence--An Extension of the Concept," pp. 16-17.

[102]Ibid., p. 18.

parties and organizations with which he is associated. The effects or influences of these conditions if uncontrolled are manifested eventually in the quality of the auditor's work, in biased reporting, and in opinions having little or no real basis in fact. The objective of adherence to the standard of independence is recognition and control of the effects before they impair independence rather than an after-the-fact type of conclusion about the auditor's maintenance of it. Because independence is a personal standard referring to the auditor's state of mind, the ultimate problem of its maintenance, except in cases of flagrant infringement, rests with the auditor.[103]

As mentioned at the beginning of the discussion, the auditor can control directly only some of the conditions--more specifically, only those emanating from himself or his personal situation. Even though he has no control or power to prevent the others, he must, to be independent, control their effect on his state of mind. The means for such control is a process of evaluation--that is, of testing--the judgments made in light of independence. A description of this process follows the discussion of indicators of independence.

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[103]Mautz and Sharaf, The Philosophy of Auditing, p. 208.

Indicators of Independence

Independence must be indicated in two senses--to the auditor who alone can know his state of mind, or independence in fact, and to others to whom he must appear independent. The indicators of independence accordingly are discussed in terms of these two aspects of independence. In many cases, they represent the existence of conditions opposite to or offsetting those which adversely affect independence.

Indicators of Independence in Appearance

Indicators of independence in appearance stem from the auditor's outward manifestations of the concept and generally refer to his relationships with others. Drawing from the same sources used in discussing conditions adverse to independence, the following are indicators of independence in appearance.

In personal situations and relationships with the audit client, independence is apparent when the auditor

1. remains clear of the preparer of financial statements or free of influences from the client by avoiding situations in which he virtually would be a part of management or an employee, by severing audit working relationships with former firm members who have become associated with clients, by avoiding outside business relationships or involvement in other capacities which

affect the client's business, and by having no financial interest in the client;

2. avoids providing preaudit services followed by audits for the same client;

3. refuses to submit to any external influence with respect to any part of the audit, or where such interference is imposed his withdrawal from the engagement;

4. establishes clear understanding with the client regarding fees and avoids competitive bidding or contingent fees;

5. avoids situations which would place his continued employment in jeopardy such as depending on only a few clients for revenues;

6. avoids or refuses to submit to restrictions on time or any other resources needed for the audit;

7. maintains a professional attitude and approach as opposed to that suggesting salesmanship or solicitation;

8. adheres to his own competent judgment regarding fairness even where his ideas conflict with those of the client;

9. avoids a too close association and identification with management of the client through, for example, dealing with clients at the highest possible level;

10. is employed or selected by other than those whose work is being audited.

Through association with a public accounting firm, the auditor's independence in appearance is indicated by the existence of organizational neutrality within the firm. That is, the auditor in charge of the engagement has authority and responsibility for the audit and opinion, the auditor acts only in the capacity of an auditor, the audit firm's personnel is divided according to audit and nonaudit services, and only experienced auditors are assigned to field work supervision. It also is indicated by support of independence from the audit firm in the form of firm policies regarding independence, lack of pressures to compromise independence, and backing from superiors for maintenance of independence.

The auditor's independence in appearance further is indicated by conditions within the auditing environment which support independence on his part and by actions of outside institutions to promote it. These include

1. a lack of privileged communication for auditors and precedence on their part toward full disclosure over confidential communication;

2. support from the profession as shown by inclusion of the concept as a generally accepted auditing standard and as a rule in its code of ethics, by its

rulings on ethics, and by professional discipline of members;[104]

3. existence of professional solidarity, or support from other professional auditors when clients attempt to change auditors;

4. insistence by the Securities and Exchange Commission on letters regarding dismissal of auditors;[105]

5. support from institutions outside the profession, most notably, that from the Securities and Exchange Commission in its accounting regulations, rulings, and releases and that from the legal profession in its rulings in court cases;

6. support from the public or third parties in the nature of a threat of serious and adverse consequences for the auditor should he not maintain independence rather than in the form of an assertive declaration to back the auditor for maintaining it--that is, the public's holding the auditor legally responsible and liable for independence.

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[104] See American Institute of Certified Public Accountants, <u>Code of Professional Ethics</u>, pp. 8-11, 20-22; American Institute of Certified Public Accountants, <u>Statements on Auditing Standards: Codification of Auditing Standards and Procedures</u>, pp. 8-10; and American Institute of Certified Public Accountants, <u>Summaries of Ethics Rulings</u>, pp. 1-52.

[105] "SEC Amends Forms 8-K, 7-Q, 10-Q, 10-K, and N-1Q," <u>The Journal of Accountancy</u> 132 (November 1971): 19-20.

Finally, the auditor's independence in appearance is indicated through his reputation; through his exercise of it--for example, his refusal to limit the investigation or disclosures at the insistence of others and his avoidance of purposely ambiguous reports; through his refusal to consciously falsify facts discovered in the audit;[106] and through his exhibiting self-reliance in establishing facts for himself, forming and accepting responsibility for his own decisions, and exercising professional judgment.

In summary, independence in appearance is indicated when none of the proscribed relationships exist between the auditor and client; when the auditor has programming, investigative, and reporting freedom; when the audit firm exhibits organizational neutrality and otherwise supports the auditor's show of independence; when the profession and other institutions support it by their policies and practices; and when the auditor shows himself to be self-reliant in forming judgments, carrying out field work, and reporting the audit results.

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[106]Rappaport, SEC Accounting Practice and Procedure, p. 26.27.

[107]Mautz and Sharaf, The Philosophy of Auditing, pp. 206-207.

Indicators of Independence in Fact

Independence in fact, while reflected in the quality of the auditor's field work and reporting, is initially indicated and can be known only to the auditor himself. Therefore, the indicators of independence in fact consist of desirable traits characterizing the independent state of mind. The process of discovering whether and to what degree these traits are present is discussed in the next section. Here, they simply are pointed out as clues to intellectual honesty.

Of overriding significance as indicators of independence in fact are the auditor's recognition and acceptance of responsibilities along with his conduct in accordance with them. Primary concern should be made to his responsibilities to third parties or the public, an obligation described in the following terms.

> He must fulfill this obligation even when it means opposing and denying the wishes of those who have employed him, and who, he knows, may cease to do so. It is a requirement unparalleled in any other field.[108]

The auditor also must give recognition to his responsibilities in other areas including a responsibility to clients to "be fair and candid . . . and serve them to the best of his ability, with professional concern for their best interests, consistent with his responsibilities to the public;" to the profession for support and conduct in a

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[108]Wilcox, "Professional Standards," p. 8.

manner promoting cooperation and good relations among its members;[109] and to himself to maintain his integrity, reputation, professional standing, and clients. Included with the recognition and assumption of responsibilities as reinforcements of independence is a true understanding of the risks and possible liabilities from a lack of independence.

Personal qualities indicating independence in fact and also tending to support it include the following:

1. concern for the maintenance of independence based on personal integrity, morals or ethics, and acceptance of responsibility;

2. self-confidence in one's judgment and audit abilities from a background of education, training, and experience and from the exercise of due care in field work and reporting;

3. confidence in the overall firm's independence or that of other members of the firm;

4. constant attention and explicit consciousness throughout the audit regarding the maintenance of independence and impairments to it since the greatest threat to independence is its "slow, gradual, almost casual erosion."[110]

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[109] American Institute of Certified Public Accountants, Code of Professional Ethics, pp. 12-16.

[110] Mautz and Sharaf, The Philosophy of Auditing, p. 208.

5. formation of definite but not inflexible ideas on what constitutes fairness as regards financial presentation;

6. the auditor remains constantly aware of his biases or preconceived ideas;

7. existence of a personal code of ethics;[111]

8. development of introspective abilities and particularly the skill of spelling out engagements as discussed under the meaning of independence;

9. the existence of clear ideas

> . . . of just how far he is willing to go in satisfying each client, to just what extent he may subordinate his personal preference, just how much he can compromise, and exactly at what point he is determined to refuse to go further with a polite statement of the reasons.[112]

10. attitudes of open-mindedness and whole-heartedness, or undivided interest, in the audit investigation;[113]

11. honest and proper handling of facts disclosed in the audit;

12. settlement of doubt regarding independence through evaluation in terms of independence of relationships with others and of judgments made in the audit.

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[111] Richard S. Woods and Ernest L. Hicks, "Decisions on Financial Statements," in _Audit Decisions in Accounting Practice_, ed. Richard S. Woods (New York: Ronald Press Company, 1973), pp. 29-30.

[112] John L. Carey, "The Realities of Professional Ethics," _The Accounting Review_ 22 (April 1947): 121.

[113] Dewey, _How We Think_, pp. 30-32.

Independence in fact, then, depends on and is indicated by the auditor's attitudes to his work; by the existence of clearly formed ideas about independence, ethics, and fairness; by a sense and acceptance of responsibilities with priority given those to third parties; and by the development of intellectual abilities to evaluate objectively his own state of mind.

Evaluating Independence

Evaluation of independence covers both aspects of the concept. Evaluation of independence in appearance is relatively objective, involving for the most part comparison of the auditor's situation with conditions which should not exist. For example, the existence of relationships proscribed by the profession would lead to the evaluation that independence in appearance was lacking. The test for independence in appearance, then, is the existence or nonexistence of the conditions which have been described as adversely affecting it. If the auditor remains in doubt as to his independence in appearance, he can seek rulings from the Division of Professional Ethics within the American Institute of Certified Public Accountants[114] or from the Securities and Exchange Commission.[115]

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[114] American Institute of Certified Public Accountants, Summaries of Ethics Rulings, p. v.

[115] "SEC Chief Accountant Speaks Before NYSSCPA," The Journal of Accountancy 129 (January 1970): 16.

Evaluation of independence in fact poses the greatest problem for the auditor since the process is a subjective one in which he tests his own state of mind. The assumptions are made here that the auditor approaches the audit with the intention to maintain intellectual honesty and that the auditor is capable of knowing his own state of mind. Writers such as Casler, have attacked approaching the problem of independence in terms of such introspective abilities by stating,

> Whether auditors are men who are capable of making such discriminating observations in situations in which they themselves are involved is at best a hypothesis which should be tested.[116]

The contention here is they are capable of such observations, that these observations are possible through a process of testing the state of mind in terms of independence qualities, and that the standard, as a personal standard, demands such capabilities. As an aside, others have attacked the very opposite condition--that is, whether men are capable of entering into self-deception or disavowal regarding engagements they are pursuing. Again the contention, supported by Fingarette, is they can.[117] These contentions basically state the auditor is capable of both intellectual honesty, or independence in fact, and lack of independence in fact, or self-deception.

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[116] Casler, The Evolution of CPA Ethics: A Profile in Professionalization, p. 11.

[117] Fingarette, Self-Deception, pp. 87-88.

The auditor is not required to enter blindly into the process of testing his independence. He has available various tools which aid him. These tools consist of a basic fund of knowledge concerning independence and personal abilities. The fund of knowledge with regard to independence includes an understanding of the meaning of intellectual honesty; an understanding of the conditions such as pressures, which adversely affect it; an understanding of the indicators of independence; and training and experience in assessing audit situations in terms of independence, meeting pressures against it, and using favorable conditions to advantage. Personal abilities which aid the auditor in evaluating his state of mind include self-control and self-discipline, introspective abilities to "continually examine himself and his work,"[118] and skill in spelling out engagements or being explicitly conscious of them.

The test to be used in evaluating independence in fact is coherence of the actual state of mind with the known properties of independence. Coherence has been described as more than mere consistency.

> Fully coherent knowledge would be knowledge in which every judgment entailed, and was entailed by, the rest of the system.[119]

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[118]Mautz and Sharaf, The Philosophy of Auditing, pp. 207-208.

[119]Brand Blanshard, The Nature of Thought, 2 vols. (New York: The MacMillan Company, 1939), 2: 264.

In testing independence, coherence means that the truthful state of the auditor's mind is coherent with the "system" of independence--that is, with the qualities of intellectual honesty. The known properties of independence logically would lead to the state of mind which exists in reality, and the state of mind which actually exists logically entails the known properties of independence. The two correspond to each other in all ways. The ultimate proof or test of truth--in this discussion, of independence in fact--is a complete integration between what is known and the judgments made on the basis of this knowledge. However, as Blanshard points out,

> . . . in common life we are satisfied with far less than this. . . . We test judgments by the amount of coherence which in that particular subject-matter it seems reasonable to expect.[120]

The auditor testing his state of mind with regard to independence cannot hope to achieve complete coherence between his actual state of mind and all the properties of independence in fact because his knowledge with respect to both is naturally limited in some respects. He cannot know everything about his state of mind in the limited time for the audit nor everything about independence as a concept; he can only approach these complete systems of knowledge.

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[120]Ibid., p. 266.

Given the tools for evaluating independence in fact and a test for it, the auditor must undertake a process of testing his state of mind in each audit situation. The process can be viewed in two ways. One is that of judging the state of mind before entering into various types of engagements. This infers looking ahead to possible effects on independence in the situation. The second way of viewing the process is that of reviewing what was the state of mind in the engagement--a process of judging possible effects on independence after they have had opportunity to act but before rendering an opinion. Both ways involve the same mental activities. While an exact description of how an auditor does or should think cannot be described, those mental activities used in testing the state of mind for maintenance of independence can be suggested. These activities involve the gathering of evidence of intellectual honesty in the form of indicators of it. The process involved in this gathering of independence indicators is that described earlier as spelling out engagements. The spelling out means assessing the audit situation in terms of independence--selecting out those conditions relevant to the auditor's state of mind--and giving explicit expression to the actual state of mind with emphasis on factors influencing it. Other mental activities involved in evaluating the state of mind are a comprehensive consideration of the various conditions regarding it--that is bringing in all related points which, if isolated, may not seem important but which, if considered in total, may be; a comparing of the auditor's state of mind and personal situation with his knowledge of independence; a consideration of the full consequences of the actual state of mind--for example, consideration of the results to which the present state of mind would lead; and removal of doubt concerning the maintenance of independence. The process of evaluation essentially is that of introspection, the "observation and contemplation of one's own mental process, and experiences; systematic self-observation."[121] The kind of thinking involved in the process is reflection, "the kind of thinking that consists in turning a subject over in the mind and giving it serious and consecutive consideration."[122]

Summary and Conclusion

Adherence to the standard of independence means the auditor has the ability to and does evaluate his state of mind in terms of intellectual honesty. The evaluation of independence in fact is a process of testing the state of mind with knowledge of what constitutes intellectual honesty. Because the testing is carried out by the

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[121] Wolman, Dictionary of Behavioral Science, p. 202.

[122] Dewey, How We Think, p. 3.

auditor in relation to his own state of mind, efforts to avoid self-deception by spelling out engagements are important. For this activity, the auditor depends on knowledge of the various aspects of independence, on the development of introspective abilities, and on self-control or self-discipline. Guidelines for adherence to independence thus include elements of the knowledge needed such as the meaning of independence, conditions adversely affecting it, and indicators of its maintenance. Since the standard also covers the independence in appearance aspect of the concept, guidelines include considerations of it.

CHAPTER VI

DUE CARE

Introduction

> Due professional care is to be exercised in the performance of the examination and the preparation of the report.[1]

Importance and Objectives of the Standard

The importance of the due care standard is derived from the auditor's professional standing and from his responsibility to third persons, or the public. As a professional, the auditor is assumed to have the degree of skill of other professional auditors and to use that skill carefully and diligently. In accepting a responsibility to third persons as well as to clients for the exercise of due care, the auditor recognizes they are justified in relying on his work and report, and, further, they possibly may be injured financially through such reliance.

The objectives of the standard are to indicate "the quality and extent of performance to be expected from

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[1] American Institute of Certified Public Accountants, Committee on Auditing Procedure, Statement on Auditing Standards: Codification of Auditing Standards and Procedures (New York: American Institute of Certified Public Accountants, Inc., 1973), p. 10.

independent auditors" and to provide limits to the auditor's responsibilities.[2] The latter objective prevents the auditor's being held to a standard of inhumanly perfect conduct by making allowance for honest mistakes, and it prevents his liability for failure to use due care running to an indeterminate number of people.

Scope of the Discussion

In discussing due care, the auditor is assumed to have at least the minimum competence required of all professional auditors and to meet the standard of independence so that due care is not undermined through his being biased. Another assumption made is the same standard of due care applies to all audit engagements, the circumstances of each determining its particular application or direction,[3] and to all auditors.

A limitation to due care results from the fact that adherence to the profession's auditing standards, while indicating due care, does not prove conclusively it has been exercised, particularly in cases of special or unusual circumstances.[4] Another limitation to the

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[2]R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (Menasha, Wisconsin: George Banta Company, Inc. for the American Accounting Association, 1961), p. 113.

[3]W. M. E. McLeod, "A Time to Reflect on Our Role," Canadian Chartered Accountant 99 (December 1971): 470-71.

[4]N. M. Stephen, "Accountant's Legal Liability," The Chartered Accountant in Australia 41 (July 1970): 4-8.

standard refers to the auditor's human characteristics of being subject to error and therefore not always infallible.

The general discussion of due care is taken from ideas regarding the concept as found in law. Then, the concept is discussed from the auditor's standpoint including conditions conducive to the exercise of due care, indicators due care has been exercised, and the process of evaluating the audit work in terms of due care. As with competence and independence, the auditor must be concerned with his exercise of due care in all matters and with that of his assistants, associates, and others on whose work he relies.

Meaning of Due Care

The concept of due care is legal in origin and is applied to all professionals as well as to any person employed by or offering services to another. As a general concept of such wide application, it ordinarily is described in very broad terms, but it can be described more specifically if related to particular professions such as auditing and discussed in terms of what is expected of a professional auditor. Here, concentration is on the general concept with passing reference to the field of auditing, leaving the more specific discussion to the following section dealing with its application to auditing.

The Profession's Description

The American Institute of Certified Public Accountants includes due care in the personal standards of auditing, stating that it relates to the auditor's qualifications and to the quality of his work.[5] As will be more fully discussed in the legal description of the concept, the particular qualification of importance in due care is that of the auditor's competence. Regarding the quality of the auditor's work, due care has two elements--"what the independent auditor does and how well he does it."[6] The first element is defined by the standards of field work and reporting.

> Due care imposes a responsibility upon each person within an independent auditor's organization to observe the standards of field work and reporting.[7]

The second element is described by the rule of conduct.

> A member shall not knowingly misrepresent facts, and when engaged in the practice of public accounting, including the rendering of tax and management advisory services, shall not subordinate his judgment to others.[8]

The duty to use care pervades all aspects of public accounting, but in auditing it directly relates to the

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[5]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 7.

[6]Ibid., p. 10.

[7]Ibid.

[8]American Institute of Certified Public Accountants, Code of Professional Ethics (New York: American Institute of Certified Public Accountants, Inc., 1972), p. 21.

auditor's responsibility for the expression of an opinion regarding financial statements which expression is based on the results of his field work and included in his report.

Legal Descriptions

Areas of Law Relevant to Due Care

The duty of care is found in three areas of law--statutory law, contract law, and tort law. While various states have statutes pertaining to auditors and in effect hold them to due care through liability for fraud or misrepresentation, the federal statutes are of most importance in describing the standard. These federal statutes are the Securities Act of 1933 and the Securities Exchange Act of 1934. In section 11 of the 1933 act, the duty is referred to as "due diligence" in the investigation and is based on the standard of care imposed on trustees.[9] Section 11(b) states

> Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof--
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> (3) that . . . (B) as regards any part of the registration statement purporting to be made upon his authority as an expert . . . (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state

[9] Wiley Daniel Rich, Legal Responsibilities and Rights of Public Accountants (New York: American Institute Publishing Company, 1935), pp. 76-86, 109-110.

> a material fact required to be stated therein or necessary to make the statements therein not misleading. . . .[10]

Section 11(c) defines the standard of reasonableness to be used in determining reasonable investigation and reasonable ground for belief as "that required of a prudent man in the management of his own property."[11] This meaning of due care recently was applied in the BarChris Construction Corporation case. In that case, the auditors failed to establish that due diligence had been exercised in the investigation or, in other words, that the audit investigation was reasonable. The auditor in charge of the assignment did not, for example, reasonably investigate various accounts nor, in the S-1 review, examine important financial records, read minutes of subsidiaries, fully follow the audit firm's written program, or further investigate questionable matters which arose.[12] Under the Securities Exchange Act of 1934, the duty appears in section 18 as action in good faith and without conscious misrepresentation. That section states,

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[10] U. S., Securities and Exchange Commission, Securities Act of 1933 (1972), p. 12.

[11] Ibid., p. 13.

[12] See Escott v. BarChris Construction Corporation, 283 F. Supp. 698-703 (1968); and John K. Shank and Mitchell N. Saranow, "The BarChris Decision--New Ground Rules for Security Registration," Financial Executive 40 (March 1972): 22-29.

> (a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title . . . which statement was at the time and in the light of the circumstances under which it was made false and misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.[13]

Contract law deals with the auditor's responsibility to his clients for the exercise of due care according to the express terms of the contract. His duty of care in terms of the contract means completely carrying out those terms skillfully so as not to invade a right created by the contract.[14]

In tort law, the duty of care primarily is discussed in relation to negligence, and that area provides the most thorough description of due care, especially as it reflects the auditor's responsibility to third parties. The exercise of due care is judged by comparing conduct in a particular instance to a standard of conduct. Conduct falling below the standard is negligence.[15]

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[13]See Rich, Legal Responsibilities and Rights of Public Accountants, pp. 86-88, 110; and U. S., Securities and Exchange Commission, Securities Exchange Act of 1934 (1970), p. 32.

[14]Rich, Legal Responsibilities and Rights of Public Accountants, pp. 7-9, 12-16.

[15]2 Restatement of the Law: Torts 9 (2d ed. 1965).

Conversely, due care is defined as "the absence of negligence."[16]

Due Care in Terms of Negligence

The standard of conduct for determining whether due care has been exercised may be referred to as the standard of care and has the following characteristics:

1. The standard of care involves considerations other than intentional harm to others, reckless disregard of others' interests, and acts for which a person is strictly liable regardless of fault on his part. While these considerations are relevant to the whole of an auditor's conduct, they do not pertain to due care. Lack of due care, or negligence, implies fault but no desire to bring about the harmful consequences nor knowledge that such consequences will follow.[17]

2. The standard of care is neither a rule of law nor a matter of fact although rules exist with regard to factors employed in determining it and the liability for measuring up to it.

> The standard is . . . what was or would have been permissible conduct in the situation in which the act was done. . . . For negligence cases the standard can be briefly described as conduct that in the light of all

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[16] Black, Law Dictionary 626 (3d ed. 1933).

[17] See Prosser, Handbook of the Law of Torts 10-11 (4th ed. 1971); and 2 Restatement of the Law: Torts 145.

> the circumstances does not create unreasonable risk to others.[18]

3. The standard of care is determined in light of particular circumstances in the situation.

> The duty which one person may owe in a particular situation for the protection of another person is measured by the exigencies of the occasion. . . . negligence is a failure to exercise the degree of care demanded by the circumstances of the particular case.[19]

4. The standard of care is based on the concept of the reasonable man.

> The words "reasonable man" denote a person exercising those qualities of attention, knowledge, intelligence, and judgment which society requires of its members for the protection of their own interests and the interests of others. . . . The fact that this judgment is personified in a "man" calls attention to the necessity of taking into account the fallibility of human beings. . . . The actor is required to do what this ideal individual would do in his place. The reasonable man is a fictitious person, who is never negligent, and whose conduct is always up to standard.[20]

5. The standard of care is determined in the light of various factors which must be balanced or weighed. Briefly these factors are the likelihood that the conduct will injure others, the seriousness of the injury if it happens, and the interest which must be sacrificed to

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[18] Seavey, Keeton, and Keeton, Cases and Materials on the Law of Torts 106 (2d ed. 1964).

[19] See 38 Am. Jur., Negligence 674-75 (1941); 2 Harper and James, The Law of Torts 929 (1956); Prosser, Handbook of the Law of Torts 150; 2 Restatement of the Law: Torts 155-56; and Throckmorton, Cooley, A Treatise on the Law of Torts 622-23 (rev. students' ed. 1930).

[20] 2 Restatement of the Law: Torts 12-15.

avoid the risk.[21] In weighing these factors, the judgment to be made is the one

> . . . which is necessary to determine whether the magnitude of the risk outweighs the value which the law attaches to the conduct which involves it. This requires not only that the actor give to the respective interests concerned the value which the law attaches to them, but also that he give an impartial consideration to the harm likely to be done the interests of the other as compared with the advantages likely to accrue to his own interests, free from the material tendency of the actor, as a party concerned, to prefer his own interests to those of others.[22]

In looking to these characteristics of the standard of care for general guides regarding due care, the last two concerning the reasonable man and factors employed in judging the standard are of most importance.

Reasonable Man

Attributes of the reasonable man important to the determination of due care

> . . . are those which are necessary for the perception of the circumstances existing at the time of his act or omission and such intelligence, knowledge, and experience as are necessary to enable him to recognize the chance of harm to others involved therein.[23]

These qualities include physical attributes, mental capacity, knowledge, superior knowledge or skill, and judgment. Regarding physical attributes, the reasonable man is identical with the actor, or person whose conduct is

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[21]Prosser, Handbook of the Law of Torts 929.

[22]2 Restatement of the Law: Torts 13-14.

[23]Ibid., p. 13.

being judged, and he is held to reasonable conduct in light of knowledge of his physical capabilities or incapacities.[24] The mental capacity of the actor, including intelligence and stability, is not necessarily identical to that of the reasonable man since he is held to an external and objective standard.[25] As Holmes noted,

> The law takes no account of the infinite varieties of temperament, intellect, and education which make the internal character of a given act so different in different men. It does not attempt to see men as God sees them, for more than one sufficient reason.[26]

Knowledge, or the reasonable opportunity to acquire knowledge, is the foundation of liability for negligence.[27] The knowledge required by the standard is that necessary to foresee the risk of injury to others through one's conduct, and it involves correlating the specific situation with past experiences. Included in this knowledge are perception of one's surroundings or situation through reasonable attention to them, memory, past experiences, common knowledge and experience with which people generally and ordinarily are charged, knowledge of one's own ignorance and abilities, how to conduct an inquiry

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[24] See 2 Harper and James, The Law of Torts 920-24; and Prosser, Handbook of the Law of Torts 151-52.

[25] See 38 Am. Jur., Negligence 671-72; 2 Harper and James, The Law of Torts 923-24; and Prosser, Handbook of the Law of Torts 152-54.

[26] Prosser, Handbook of the Law of Torts 152.

[27] 38 Am. Jur., Negligence 665.

concerning what one does not know, knowledge and experience related to the particular activity in which one is engaged, and current advances in one's particular field.[28] Of significance in determining due care in a particular situation are the knowledge actually possessed and that which should have been possessed at the time.[29] Superior knowledge and skill especially are applicable to professionals who are held to possess the minimum skill required by that profession as measured according to others of good professional standing. In addition to the minimum, this attribute of superior knowledge and skill includes a greater degree of competence than other professionals have if the person holds himself out as a specialist or expert in some area of his profession.[30] The basic standard is not that of the average member of the profession since only those in good standing, not those who do not meet the minimum, should be considered and since the minimum skill, not the middle degree of skill, is relevant.[31] Finally, the actor is held to exercise the judgment of a reasonable man in all senses

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[28] See 38 Am. Jur., Negligence 665-67; 2 Harper and James, The Law of Torts 907-17; and Prosser, Handbook of the Law of Torts 1, 157-61.

[29] 2 Harper and James, The Law of Torts 908.

[30] See 2 Harper and James, The Law of Torts 917-20; and Prosser, Handbook of the Law of Torts 161-66.

[31] Prosser, Handbook of the Law of Torts 163.

of that term. As with mental capacity, knowledge, and skill, this judgment is evaluated by an external standard, not simply in terms of the actor's exercising his own judgment. While he is not held to infallibility, he also is not permitted to determine due care according to his own best judgment but must instead exercise the judgment of the reasonable man.[32]

For auditors, the standard of conduct by which due care is evaluated becomes the conduct of the reasonable auditing practitioner whose attributes meet those commonly possessed by others of good standing. Paralleling the legal ideas of the reasonable man, attributes of the reasonable auditing practitioner include superior skill and knowledge. He is expected to possess the minimum knowledge and skill demanded by the profession as well as that which should be possessed in each audit situation to foresee risk of injury to others. In addition, the auditor must have the ability to exercise the judgment other professional auditors in good standing are capable of exercising. These attributes are manifested in the conduct and quality of the auditor's work--an aspect of due care more fully discussed under indicators of due care.

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[32]See 38 Am. Jur., Negligence 679; and 2 Harper and James, The Law of Torts 906-907.

Important Factors in Determination of Due Care

The factors employed in determining the standard of care covering the risk of injury to third persons, the seriousness of the injury, and the interest to be sacrificed to avoid the risk describe the considerations to be made in exercising due care. They include the following:

1. Recognizing the existence of risk--This consideration means anticipating and guarding against any reasonable risk or probability of injury to others which may result from the intended conduct.

> The probability of injury by one to the legally protected interests of another is the basis for the law's creation of a duty to avoid such injury. Every person is under a duty to exercise his senses and intelligence in his actions in order to avoid injury to others, and where a situation suggests investigation and inspection in order that its dangers may fully appear, the duty to make such investigation and inspection is imposed by law. . . . Generally speaking, no one is bound to guard against or take measures to avert that which, under the circumstances, a reasonably prudent person would not anticipate as likely to happen.[33]

This recognition of risk calls for the attention and perception of the reasonable man to his circumstances, which in turn are conditioned by memory of previous experiences correlated with the circumstances at hand, distractions to attention, minimum knowledge as well as any superior qualities which are or should be possessed, and actual

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[33] 38 Am. Jur., Negligence 667-71.

foresight or reasonable foreseeability of the consequences of the conduct.[34]

2. Knowledge necessary to recognize the existence and extent of a risk of injury to others--

> It is no excuse that one who has created a peril did not intend or expect an injury to result therefrom; every person is held to a knowledge of the natural and probable consequences of his acts. One under duty to use care for which knowledge is necessary cannot escape liability for negligence because of voluntary ignorance. . . . Knowledge or the opportunity to acquire knowledge of the peril involved in an act is fundamentally the basis of the duty to use care to avoid injury to another person.[35]

Considerations of knowledge involve what reasonably must be possessed at the time and under the circumstances, what is known of or believed to be the facts in the circumstances, and the known tendency of others to expose themselves to the danger of injury.[36]

3. Unreasonableness of the risk--This factor emphasizes that the basis of negligence is behavior involving unreasonable danger to others, not simply careless behavior or behavior involving a remote possibility of harm or harm not reasonably to be anticipated.

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[34] See 38 Am. Jur., Negligence 669, 678-79, 707-10; 2 Harper and James, The Law of Torts 907-17; Prosser, Handbook of the Law of Torts 145; and 2 Restatement of the Law: Torts 41-47.

[35] 38 Am. Jur., Negligence 667-71.

[36] See 2 Harper and James, The Law of Torts 907-20; Prosser, Handbook of the Law of Torts 157-66; and 2 Restatement of the Law: Torts 47-54.

> The greater the danger which is known or is reasonably to be anticipated, the greater is the degree of care which is required to be observed. . . . The surrounding facts and circumstances are of controlling importance. . . . The rule which required ordinary care prevails at all times, but ordinary care may be a high degree of care under some circumstances and a slight degree of care under other circumstances.[37]

Considerations to be made in determining unreasonableness of the risk involve balancing, on the basis of foresight, the magnitude or gravity of the risk--or, conversely, the seriousness of the injury--and the utility of the conduct--conversely, the value of the interest to be sacrificed in avoiding the risk. Negligence results if the risk of injury outweighs the utility of the conduct. Utility of conduct refers to the value attached to it or to the interest such conduct advances. Although conduct may involve the possibility of harm, it still may be judged valuable to society. For example, the auditor's rendering an opinion on financial statements carries with it the possibility someone may be injured through reliance on it, but such auditing conduct is judged to have utility to society as a whole and to advance the interest or good of the general public. In evaluating the utility of conduct, consideration also should be given to the interests of the auditor or others, such as the client in auditing situations, and to any alternative courses of action available involving less risk of harm. In determining magnitude or gravity of the risk, consideration

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[37] 38 Am. Jur., Negligence 675.

should be given to the quantitative probability of injury or harm, the seriousness or extent of the injury should it happen, the number of persons likely to be harmed, and the social value attached to the various interests involved. If the actor has a duty to more than one person or class of persons and if his alternative courses of action involve a risk of harm to someone, he must select that course of least risk to those under his protection. Relating this to auditing, the auditor facing the alternatives of risking harm to himself, to his client, or to third parties would, in exercising due care, not expose third parties to harm. Such due care does not mean exposing others to a greater risk of harm where only a slight risk to third parties is involved.[38] In summary, the test for determining the unreasonableness of risk is expressed in the following formula.

> The degree of care demanded of a person by an occasion is the resultant of three factors: the likelihood that his conduct will injure others, taken with the seriousness of the injury if it happens, and balanced against the interest which he must sacrifice to avoid the risk.[39]

The question to be answered is whether "the game is worth the candle."[40]

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[38] See 2 Harper and James, The Law of Torts 928-36; Prosser, Handbook of the Law of Torts 145-49; and 2 Restatement of the Law: Torts 45-62.

[39] L. Hand, J. in Conway v. O'Brien, 111 F 2d 612 (2d Cir. 1940).

[40] 2 Restatement of the Law: Torts 55.

4. Custom--As a consideration in determining due care, custom--what is usually done by the community or particular group of people--is relevant. The individual's conformance with his own habits or customary conduct is not a determinant of due care. Conduct consistent with that of others infers conformance with the standard of care, and conduct inconsistent with custom implies non-conformance with the standard. However, custom is not a controlling or conclusive test in all circumstances. It does not control if the circumstances are such that custom would be unreasonable conduct or where the customs themselves are inadequate, negligent, careless, or dangerous. In the Continental Vending case, this point was made clear when the judge refused to allow compliance with generally accepted accounting principles as the only test of fairness in evaluating financial statement presentation and also approved instructions allowing conviction of the auditors for deficiencies in their work even if their work conformed to the recognized standards of the profession.[41]

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[41]See "AICPA Brief in Continental Vending," The Journal of Accountancy 129 (May 1970): 71-73; 38 Am. Jur., Negligence 679-82; Donald Stuart Bab, "Current Thoughts About the Legal Liability of the CPA," The New York Certified Public Accountant 41 (June 1971): 442; A. Beedle, "Lessons from the Continental Vending Case," Canadian Chartered Accountant 98 (May 1971): 354; 2 Harper and James, The Law of Torts 977-82; Prosser, Handbook of the Law of Torts 166-68; 2 Restatement of the Law: Torts 62-64; Gordon Samuels, "Protecting Your Practice Against Liability," The Chartered Accountant in

5. Emergency--In determining due care, consideration should be given to sudden and unexpected emergencies which affect conduct, but the actor still is held to reasonable conduct even though such conduct may not be that followed by one who had time for full reflection of its consequences. Furthermore, the standard of care may require anticipation of emergencies likely to arise in the particular line of activity, and it does not excuse one who has himself created an emergency through negligence.[42]

In summarizing the effect these considerations have on due care, the following remarks are pertinent.

> . . . the problem of duty is as broad as the whole law of negligence, and . . . no universal test for it ever has been formulated. It is a shorthand statement of a conclusion, rather than an aid to analysis in itself. It is embedded far too firmly in our law to be discarded, and no satisfactory substitute for it, by which the defendant's responsibility may be limited, has been devised. But it should be recognized that "duty" is not sacrosanct in itself, but only an expression of the sum total of those considerations of policy which lead the law to say that the particular plaintiff is entitled to protection.[43]

While conclusions regarding due care are relevant to the field of auditing and must be drawn before reliance can be placed on the auditor's opinion, they are formed by those who rely on his report or by a court in situations of doubt regarding the actual exercise of due care. The

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Australia 41 (August 1971): 8; and United States v. Simon, 425 F. 2d 805, 806 (1969).

[42]See Prosser, Handbook of the Law of Torts 168-70; and 2 Restatement of the Law: Torts 64-65.

[43]Prosser, Handbook of the Law of Torts 325-26.

auditor, however, does need an "aid to analysis" for adherence to this personal standard. That aid to analysis, presented below, consists of indicators of due care and a process of evaluating judgments made during the audit in terms of due care. These two aspects constitute the main body of guidelines for adherence to due care.

Indicators of Due Care

Due care ultimately is indicated in the quality of the auditor's field work and reporting, but the auditor striving to adhere to the standard needs indicators which he himself can observe before drawing conclusions and rendering an opinion. These indicators include the existence of an environment containing conditions conducive to or necessary for due care, conduct reflecting the various factors applied in law to test due care, and adherence to the standards of field work and reporting which adherence reflects considerations involved in their proper execution.

Environmental Conditions Indicating Due Care

Adherence to due care requires an auditing environment conducive to it, and this environment consists of various personal, organizational, and professional factors or conditions either tending to promote, being necessary for, or indicating the exercise of due care.

Personal Factors

Personal factors refer to the auditor's abilities, his state of mind or attitude toward the audit, and his professional development. Most important of his abilities, as already discussed, is his competence or knowledge and skill as a professional auditor. Indicators of technical competency are the auditor's education, training, and experience. Beyond technical skills, competence is indicated by the auditor's intellectual abilities to reason, to draw conclusions from his work, to form judgments, and to objectively and critically evaluate his work in terms of due care. Communicative abilities, also important elements of competence, are indicated by the auditor's personal relationships with the client and other members of the audit firm and by his abilities to work with other people, particularly as a member of an audit team.

The auditor's state of mind or attitudes which are important indicators of due care generally are the same as those indicating independence--a personal code of ethics including ideas of right conduct; acknowledgment and acceptance of responsibilities attaching to the work and reporting; open-mindedness or receptivity to new ideas and facts even if they challenge beliefs; and wholeheartedness, or undivided interest in and full attention, to the situation. Like independence, adherence to the standard calls for the desire or intent to exercise due care.

> Knowledge of the methods alone will not suffice; there must be the desire, the will, to employ them. This desire is an affair of personal disposition. But on the other hand the disposition alone will not suffice. There must also be understanding of the forms and techniques that are the channels through which these attitudes operate to the best advantage.[44]

These forms and techniques in auditing are represented in the field work and reporting standards, important considerations for which are covered below. Perhaps the most important attitude is that of a settled and clear conclusion--a state of belief as opposed to doubt--or knowledge, regarding the audit. However, as Dewey illustrates in the following description of the careful move to this mental state, other attitudes such as alertness, inquisitiveness, and skepticism are important.

> The commonest fallacy is to suppose that since the state of doubt is accompanied by a feeling of uncertainty, knowledge arises when this feeling gives way to one of assurance. . . . Tendency to premature judgment, jumping at conclusions, excessive love of simplicity, making over of evidence to suit desire, taking the familiar for the clear, etc., all spring from confusing the feeling of certitude with a certified situation. Thought hastens toward the settled and is only too likely to force the pace. The natural man dislikes the dis-ease which accompanies the doubtful and is ready to take almost any means to end it. Uncertainty is got rid of by fair means or foul. . . . Love for security, translated into a desire not to be disturbed and unsettled, leads to dogmatism, to acceptance of beliefs upon authority, to intolerance and fanaticism on one side and to irresponsible dependence and sloth on the other.
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> Here is where ordinary thinking and thinking that is scrupulous diverge from each other. The natural man is impatient with doubt and suspense; he

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[44] John Dewey, How We Think (Boston: D. C. Heath and Company, 1933), p. 30.

> impatiently hurries to be shut of it. A disciplined mind takes delight in the problematic, and cherishes it until a way out is found that approves itself upon examination. The questionable becomes an active questioning, a search; desire for the emotion of certitude gives place to quest for the objects by which the secure and unsettled may be developed into the stable and clear. . . . Being on the alert for problems signifies that mere organic curiosity, the restless disposition to meddle and reach out, has become a truly intellectual curiosity, one that protects a person from hurrying to a conclusion and that induces him to undertake active search for new facts and ideas. Skepticism that is not such a search is as much a personal emotional indulgence as is dogmatism.[45]

Other indicators of due care on the part of the auditor include his advancement within the firm and corresponding assignment as well as successful handling of greater responsibilities. In particular, due care may be indicated in supervisors' reports which concern the degree of care exercised in audits, the quality of work performed, and the acceptance and handling of responsibilities.

Organizational Factors

Organizational factors conducive to due care refer to conditions within the public accounting firm which provide an auditing environment favorable to the exercise of due care. Indicators of favorable organizational conditions are the existence of firm-wide audit policies and methods in the form of written audit manuals, checklists, questionnaires, and procedures; adequate training

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[45]John Dewey, The Quest for Certainty: A Study of the Relation of Knowledge and Action (New York: G. P. Putnam's Sons, 1929), pp. 227-28.

and opportunities for varied experience; active control of audits and review by qualified supervisors; and the existence and assignment of adequate resources to audits including experienced auditors, experts or specialists, and sufficient time. These organizational conditions in effect provide the auditor with the necessary means for exercising the knowledge and skill which he has and with the necessary support for his exercising due care. Their existence, in turn, indicates a favorable environment for due care.

Conditions Within the Profession

Professional conditions conducive to the exercise of due care include literature of an official or authoritative nature which the auditor can use as guides or directives in determining due care. This literature, in the form of research material, articles, and official pronouncements on rules and standards, indicates leadership within the profession for the exercise of due care.

Another condition within the profession is custom--what ordinarily is done or generally accepted as the exercise of due care. Regarding custom, due care is indicated by the existence or actual employment of high standards of care--that is, by the performance of highly professional audit work and by the existence of excellent auditing procedures, methods, and techniques for exercising due care.

Other indicators of due care from conditions within the profession are a high average level of education for practitioners and support for the exercise of due care.

Legal Factors Indicating Due Care

In light of the legal concepts of due care, some general or broad conclusions may be drawn regarding indicators of due care in auditing. Referring to the area of statutory law, due care in auditing includes and is indicated by compliance with provisions of the statutes. However, compliance will not in itself be conclusive proof of due care if circumstances other than those contemplated by the statutes demand additional precautions. Therefore, compliance with statutory provisions is only a minimum condition for due care.

In relation to contract law, due care is indicated by carrying out the express provisions of the contract as well as those conditions implied from the ordinary examination according to generally accepted auditing standards. As with statutory law, compliance with the express provisions of contract would only serve as a minimum condition for due care.

Considering the law of torts in the area of negligence, due care is described in the following quotation, the aspects of which touch upon many of the auditor's qualities.

> Every man who offers his service to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is prerequisite, if one offers his service, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error. He undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.[46]

Due care in auditing is measured in terms of the reasonable or prudent auditor and the minimum skill commonly possessed by other professional auditors. Bringing such skill to bear on the audit and, in addition, exercising any special skill possessed above the minimum required of all auditors, then, indicate the exercise of due care. Other indicators in this area include:

1. anticipating and guarding against reasonably foreseeable risks of injury involved in audit activities through attention to and perception of the circumstances in light of actual knowledge possessed which at least meets the minimum required of auditors; correlating previous audit experiences and knowledge with the circumstances of the audit; acknowledging the foreseen probable

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[46]American Institute of Certified Public Accountants, <u>Statement on Auditing Standards: Codification of Auditing Standards and Procedures</u>, p. 10.

consequences of the activities and conduct or, where such foresight is lacking, acquiring it by inquiry and investigation; not being unreasonably distracted; and applying any superior skills possessed to the circumstances.

2. avoiding behavior which involves unreasonable risk of danger to others through applying a greater degree of care and caution to the more dangerous activities; weighing the magnitude of the risk, including the seriousness of the possible injury from the conduct, against the utility of such conduct; and selecting, where alternatives exist, that which causes the least risk of injury primarily to third parties, the exception being where such risk to third parties is slight compared with that to others.

3. conforming to standards of conduct customary of the profession as long as they are reasonable in the circumstances and reasonable in themselves--that is, neither negligent, careless, dangerous, nor inadequate.

4. anticipating any emergencies likely to occur or, in sudden and unexpected emergencies, behaving as reasonably as possible.

Adherence to the Standards of Field Work and Reporting

As brought out earlier, due care is defined as imposing "a responsibility upon each person within an independent auditor's organization to observe the standards of field work and reporting."[47] Observation of, or adherence to, these standards, then, may be viewed as indicative of the exercise of due care in the audit. With regard to each standard, due care is indicated by considerations taken into account in observing it. Considerations important in each are discussed below.

Adequacy of Planning and the Timing of Field Work

The standard of planning states,

> The work is to be adequately planned and assistants, if any, are to be properly supervised.[48]

As stated, the standard considers opposite ends of the audit--its initial planning and, before reporting the results, review of the work done--as well as supervision.[49] Essentially, three types of knowledge are necessary for planning--

1. Accurate knowledge of prediction covering the scope of that which is to be planned.
2. Accurate knowledge of the activity for which the plan is designed.
3. Accurate knowledge of the ways and means available or which can be created to control the performance of the plan.[50]

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[47]Ibid.

[48]Ibid., p. 11.

[49]Weldon Powell, "Audits--Planning and Review," _The New York Certified Public Accountant_ 22 (February 1952): 108.

[50]John G. Glover, _Fundamentals of Professional Management_, rev. ed. (New York: Simmons Boardman Publishing Corp., 1958), p. 79.

The third element encompasses the auditor's background auditing knowledge, skill, and experience applied to the particular circumstances of the engagement. The first two are acquired through research undertaken before the audit is planned, and they form a basis for the plan. As an indicator of due care, adequate planning,then, can be viewed in terms of its scope, its effectiveness in a particular engagement, and its control.

Regarding the scope of an audit, due care is indicated by activities for defining the scope which includes the extent of responsibilities assumed and by communication between the auditor, his staff, and the client. In this respect, due care is directed primarily to the auditor's responsibilities to the client and to his limiting the possibility of liability due to misunderstandings. Indicators of due care from such activities include the following:

1. identification of the entity to be audited as to businesses included; characteristics such as reputation, business nature, history, and organizational and physical structures; policies and procedures; personnel; and related prior statements, reports, or working papers. Specific audit procedures for accomplishing this identification include inquiry; verbal communication with the client; preparation of arrangement memoranda as the basis for an engagement letter; review of prior years' working

papers, financial statements, and the work of the internal audit staff; inspection of physical plant facilities, written policies, and organization charts; and observation of the routines followed and controls in practice.[51]

2. confirmation of the audit engagement in terms of the type of services to be performed so that a mutual understanding exists between the auditor and client concerning the scope of the audit, use of the client's staff, fees, responsibilities assumed or not assumed by the auditor, and the effects of any client imposed limitations or special circumstances. Specifically, such confirmation should be written in the form of engagement letters and management representation letters based on open discussions with the client.[52]

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[51]See Douglas R. Carmichael and Thomas R. Hanley, "Audit Arrangements and Engagement Letters," The Journal of Accountancy 130 (June 1970): 70-71; Powell, "Audits--Planning and Review," pp. 112-13; and Ivor B. Wright, "Guidelines for First-Time Audits," The CPA Journal 42 (March 1972): 198-99.

[52]See Carmichael and Hanley, "Audit Arrangements and Engagement Letters," p. 71; Douglas R. Carmichael and Joe R. Fritzemeyer, "A 'Letter of Understanding' for Unaudited Statements," The Journal of Accountancy 132 (November 1971): 74-75; Earl F. Davis and James W. Kelley, "The Engagement Letter and Current Legal Developments," The Journal of Accountancy 134 (December 1972): 54-59; Philip L. Defliese, "The 'New Look' at the Auditor's Responsibility for Fraud Detection," The Journal of Accountancy 114 (October 1962): 38-39; Robert L. Gray, "Letters of Engagement," The New York Certified Public Accountant 41 (October 1971): 719; Charles B. Hellerson, "Client Engagement Letters Are in Your Best Interest," The Journal of Accountancy 123 (June 1967): 62-64; Powell, "Audits--Planning and Review," 112-13; U. S., Comptroller General, Standards for Audit of Governmental Organizations, Programs,

3. identification, through inquiry and review of the organization chart, of the managerial level to which the auditor should and will report.[53]

4. identification of unusual circumstances or relationships.[54]

5. determination of the audit's feasibility in terms of its scope and the availability of resources such as staff, time, and cost assignable to it. Specific techniques for this include estimating the completion time of each step for each grade of auditor and using the auditing firm's cost estimates in determining the total cost.[55]

With reference to effectiveness and control of an audit plan, due care is indicated by meeting the criteria or concepts of good planning as found in planning theory. Such concepts, based on various dimensions of a plan, have been discussed at length by Le Breton and Henning in Planning Theory, and their treatment of the subject is the basis of the remaining discussion.[56]

Activities & Functions (1973), p. 20; and Wright, "Guidelines for First-Time Audits," p. 197.

[53]W. J. Kenley, "Legal Decisions Affecting Auditors: Comments on the Pacific Acceptance Corporation Case," The Australian Accountant 41 (May 1971): 156.

[54]Mautz and Sharaf, The Philosophy of Auditing, pp. 135-38.

[55]Walter B. Meigs, E. John Larsen, and Robert F. Meigs, Principles of Auditing, 5th ed. (Homewood, Illinois: Richard D. Irwin, Inc., 1973), pp. 113-14.

[56]Preston Le Breton and Dale A. Henning, Planning Theory (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1961).

As an indicator of due care, the plan's effectiveness in a particular engagement depends on its consideration of the various dimensions of an audit and on its degree of completeness with respect to the engagement. Dimensions of an audit plan, consideration of which indicates due care, include:

1. the plan's complexity, meaning its major components as well as the available alternatives, the available assistance for planning such as written policies or specialists and experts, the technical nature of the activity being planned, the divisibility of the plan into logical parts, and the interrelationship of the various parts of a plan. Auditing plans become complex, for example, because of the need for simultaneous examinations; the need for some verification work to precede others; the need for experts in auditing highly technical systems requiring special verification methods; the existence of alternative means of carrying out audit objectives; and depending on findings, the necessity of altering the plan. One example of complexity due to the interrelationships of parts of a plan is that between evidence gathering and internal control evaluation in which evidence is gathered concerning internal control, and the evaluation of internal control in turn determines the extent of further testing, or evidence, needed. Another is the interrelationships between the various accounts which mean they have implications for each other.

> The more complex a plan, the greater the need for precise planning tools, the more difficult coordination and control, and the greater the skill required of the planner.[57]

2. the significance of the plan to the audit firm in terms of the magnitude or size of the engagement, not in terms of the revenues it will bring. In exercising due care,

> To guage the scope and extent of an audit investigation by the amount of fees anticipated to be recoverable is unrealistic, dangerous and extremely unprofessional. . . . To admit to conducting insufficient inquiries due to lack of either time or fee recovery is tantamount to negligence.[58]

Taken in this vein, the more significant a plan, the greater is the likelihood planning will be separated from performance, the plan will become a team effort, and the higher in the organization one must go for authorization and approval of the plan.[59] A large audit engagement is significant in the sense it means more complicated and more involved planning--planning occurs at higher levels within the firm, involves more and higher level staff, calls for greater supervision, demands more coordination, and may mean more time devoted to the audit. In addition, large engagements are significant due to the need for preliminary audit work, interim audits, perhaps a greater reliance on and more involved review of internal

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[57]Ibid., p. 338.

[58]McLeod, "A Time to Reflect on Our Role," p. 471.

[59]Le Breton and Henning, <u>Planning Theory</u>, p. 339.

control, and the need to use sampling techniques in the examination.

3. the comprehensiveness of the plan in relation to the audit firm--that is, the number of departments within the firm affected and the level at which the plan is made. In auditing, for example, the engagement may require use of specialists in the areas of tax, law, computers, or others and therefore require greater skill as an element of due care. One advantage the partnership form has for public accounting firms is it allows specialization by the partners who become experts in various areas and who can then supervise or aid in audits of a comprehensive nature.[60] As a plan becomes more comprehensive, authorization and approval for it occur higher in the organization, coordination in planning becomes more complex and important, greater team effort is required, planning is separated from performance, firm policies are more closely followed, and implementation and control are greater problems.[61]

4. timing of the plan, meaning preparation time, lead time for undertaking parts of the plan, time for full plan implementation, and future time anticipated as the

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[60]See Meigs, Larsen, and Meigs, Principles of Auditing, p. 97; and Howard F. Stettler, Auditing Principles, 2d ed. (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1961), p. 116.

[61]Le Breton and Henning, Planning Theory, p. 339.

basis of a plan. The importance of time in auditing is indicated by the title of this first field work standard, adequacy of planning and the timing of field work. Examples of timing considerations are the time of the auditor's appointment in relation to the time needed for the examination, convenience of the auditor and client, the need for surprise or simultaneous examinations, proper cut-off dates for verification of accounts, the period significant for determining the effect of subsequent events, interim and year-end examinations, the lapse of time needed to determine or verify such items as unrecorded liabilities, and the necessity for estimating the required time for completing the entire audit so that pressures to finish are avoided.[62] The greater the preparation time, the greater are the chances basic premises of the plan will change and the greater are opportunities to pretest its components; the longer the lead time and implementation time for various parts of the plan, the greater are the chances basic premises will change and the greater is the need for coordination and control of the plan's components; the longer the period used as the

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[62]See David B. Isbell, "The Continental Vending Case: Lessons for the Profession," The Journal of Accountancy 130 (August 1970): 40; Philip M. Piaker, "The Distinctive Characteristics of Small Company Audits," The CPA Journal 42 (January 1972): 42; and Powell, "Audits--Planning and Review," pp. 110-11.

basis of planning, the more difficult the acquisition of accurate and precise premises.[63]

5. the plan's specificity, or the detail with which it is formulated. Specificity depends on firm policy, length of time from plan formulation to implementation, significance and complexity of the plan, and alternatives available for various plan components. If a plan is too general, it may not be implemented properly, but it should not be so specific as to cover policies or procedures already set by the firm or which are established as routine. Specificity may be based on the existence of standard programs such as those related to internal control and their applicability to the circumstances, on the novelty of the situation, on repeat engagements, and on the experience of the staff--the more seasoned staff requiring a less specific or more general plan than a less mature one.[64] Specificity may concern, for example, the amount of detail regarding procedures to be followed, the assignment of staff to particular audit steps, time assigned to parts of the plan, or the evidence to be gathered. The greater

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[63]Le Breton and Henning, Planning Theory, p. 339.

[64]See Institute of Chartered Accountants Research Society--Queensland (Australia) Division, Audit Research Group, "Audit Work Papers," The CPA Journal 42 (May 1972): 384-85; T. W. McRae, "Integrating Statistical Sampling Into Conventional Auditing Procedures," The Australian Accountant 41 (June 1971): 204-206; Powell, "Audits--Planning and Review," pp. 114-18; and Stettler, Auditing Principles, pp. 120-21.

the degree of specificity, the easier are presentation of a fully integrated master plan, communication and persuasion, implementation, and coordination and control.[65]

6. the plan's completeness in that it is tailored to the specific situation and covers all variables in the engagement.[66] Completeness means the plan covers all auditing standards, all steps necessary for adhering to the standards, coordination of all aspects of the audit, and all resources needed for the audit. Auditors can refer to standard programs, previous working papers, and firm procedures for guides in formulating a complete plan. The more complete a plan, the greater its chances of success and the easier are implementation, communication, persuasion, coordination, and control.[67]

7. the plan's flexibility, referring to its versatility and to the changeability of objects or components within it. Flexibility depends on restricted use of items contained in the plan, provisions for alternative courses of action, and rigidity of the planning process. To keep plans flexible even where based on standardized procedures and policies, the audit firm may use flexible standard programs which provide audit planning guides but which allow flexibility in the selection of procedures and

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[65]Le Breton and Henning, Planning Theory, p. 340.

[66]Stettler, Auditing Principles, p. 119.

[67]Le Breton and Henning, Planning Theory, p. 340.

other factors of implementation.[68] As Stettler has noted,

> Each procedure should be subject to modification as the audit progresses if conditions prove not to be as anticipated or if excessive errors or the suspicion of fraud enter the picture.[69]

"The greater the flexibility of a plan, the greater the need for coordination and control, and the easier communication and persuasion become."[70]

8. the frequency with which a plan is prepared, varying with the degree of permanence associated with the plan's elements; changes in the economy or changes in the client's organization; and the audit firm's resource capacity. Careful planning keeps the auditor alerted to change through anticipation of the need for adjustment, providing for all known factors,[71] and taking into consideration unusual conditions or probable areas of change. Referring to frequency, Weldon Powell noted,

> In the planning and the execution of an audit there is a fuzzy area where the two overlap to a considerable extent. On many occasions a process similar to that of trial and error is followed. A preliminary survey is made, a partial or tentative program of work is laid out, and some operations are undertaken. In the light of the results obtained, the program is completed or revised, and the examination proceeds.

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[68] Powell, "Audits--Planning and Review," p. 114.

[69] Stettler, Auditing Principles, p. 121.

[70] Le Breton and Henning, Planning Theory, p. 340.

[71] Glover, Fundamentals of Professional Management, p. 79.

> This is especially likely to be the case in a new engagement where there is no experience to serve as a guide in considering the examinee's accounting arrangements and evaluating his internal control.[72]

The more frequently a plan is formulated, the less important are long-range premises, the more likely is the routinization of the planning process, and the shorter is the planning period.[73]

The third aspect of planning which indicates the exercise of due care is control over the plan. Indicators of due care in this area are as follows:

1. the plan's confidentiality which refers to its contents being known only to authorized personnel. Confidentiality is important in two senses--that of safeguarding the contents of the plan from being manipulated or known by members of the client's organization and that of safeguarding information about the client's business from its competitors or employees.[74] The more confidential a plan, the higher up in the organization is its authorization, the fewer are the people concerned with its preparation and implementation, and the greater is the problem of assembling the plan's premises.[75] In the

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[72]Powell, "Audits--Planning and Review," p. 112.

[73]Le Breton and Henning, Planning Theory, p. 340.

[74]See American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 69-70; and Meigs, Larsen, and Meigs, Principles of Auditing, pp. 276-77.

[75]Le Breton and Henning, Planning Theory, p. 341.

recent scandal involving the Equity Funding Corporation, audit steps were anticipated and circumvented because one of the client's executives obtained access to the plan when one of the auditors left his bag unlocked overnight. The case illustrates the necessity of keeping the audit plan confidential.[76]

2. the plan's formality, referring to the use of formal or standard procedures in planning and varying with complexity, comprehensiveness, significance, and authorization level. In auditing, standard programs may be used as starting points, the planner then adding or deleting steps according to the needs of the engagement. Besides standard programs, formality is introduced into a plan through the profession's auditing standards and their official interpretations and through the firm's formalized policies, procedures, detailed audit programs, manuals, generalized audit programs for auditing computer systems, sampling techniques, and rules for working paper organization and content. The greater the degree of formality, the greater the ease with which the plan is accepted and controlled and the more likely some flexibility will be lost.[77] The necessity of considering the inclusion of formally adopted planning procedures in adhering to due care was illustrated in the BarChris Construction case. In that case, the

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[76] William E. Blundell, "A Scandal Unfolds," Wall Street Journal, 2 April 1973, p. 3.

[77] Le Breton and Henning, Planning Theory, p. 341.

auditor did not exercise due care because, among other things, he failed to take steps prescribed in the firm's written program.[78]

3. the plan's authorization, meaning only officially approved plans are prepared or implemented and varying with complexity, comprehensiveness, significance, and level of plan authorization. The more official a plan, the easier are cooperation, coordination, and control and the quicker is the performance of the planning process.[79] Authorization for the audit plan is important in establishing responsibility for it and for the work to be carried out under its provisions. Those responsible for the audit not only must insist on approving the plan but also must control the plan so only authorized procedures are followed. Acceptance of responsibility for the plan is thus predicated on the means to control it. Authorization of the audit plan by qualified, experienced supervisors also is a means of maintaining uniform standards of field work.[80]

4. the plan's implementation, the ease of which is influenced by the plan's complexity, the understanding of and response to the plan by those responsible for its

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[78]Escott v. BarChris Construction Corporation, 283 F. Supp. 703 (1968).

[79]Le Breton and Henning, Planning Theory, p. 341.

[80]Meigs, Larsen, and Meigs, Principles of Auditing, p. 98.

implementation, the plan's internal logic, and the manner in which the planning process was performed. For audit purposes, implementation is part of staff management in assigning staff to the engagements, supervision, and the general oversight by the partners.[81] It is facilitated by use of qualified, experienced, and trained staff as well as by good supervision and communication. The greater the ease of implementation, the shorter the implementation period, the greater the ease of coordination and control, and the greater the chances of the plan's success.[82]

Control means insuring that the plan is performed as scheduled, and it depends on the nature of the planning process; the tools available for measuring performance; and the precision and accuracy in satisfying the plan's premises, of the plan itself, and in establishing performance standards. The greater the ease of control of a plan, the greater is the likelihood needed plan modifications will be detected quickly and early, the more probable is the placing of major plan elements at lower levels in the organization, and the easier is coordination.[83] Control relates to audit supervision which is influenced by the quality of staff, the quality of supervision, the

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[81] Powell, "Audits--Planning and Review," pp. 109-10.

[82] Le Breton and Henning, Planning Theory, p. 341.

[83] Ibid., p. 342.

staff's understanding and acceptance of the plan, organization of the work, and the manner and degree of detail of initial planning.[84] Supervision of assistants and review of their work are necessary for control of the plan's implementation in that a plan is inoperable if its elements are not controllable,[85] and they indicate exercise of due care and skill.

> Exercise of due care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the examination.[86]

In addition to controlling the plan, supervision and review indicate the possession of competence upon which the exercise of due care is based.

> The junior assistant, just entering upon an auditing career, must obtain his professional experience with the proper supervision and review of his work by a more experienced superior. . . . The auditor charged with final responsibility for the engagement must exercise a seasoned judgment in the varying degrees of his supervision and review of the work done and judgment exercised by his subordinates, who in turn must meet the responsibility attaching to the varying gradations and functions of their work.[87]

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[84]See Peter King, "What Is On-the-Job Training?" The Chartered Accountant in Australia 41 (January 1971): 27-28; and Powell, "Audits--Planning and Review," pp. 220, 228.

[85]Glover, Fundamentals of Professional Management, p. 78.

[86]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 10.

[87]Ibid., pp. 7-8.

The scope of the supervision and review certainly extends to the audit staff under the auditor's direction, but it also extends to specialists who may be called in as consultants. A greater degree of care must be indicated by supervision of specialists and review of their work when they are not proficient as auditors than when they are so qualified.

> The accountant-in-charge of the engagement may not fully understand the technical field in which these individuals are operating and may not be able to understand the detailed technical aspects of their work. He is, nevertheless, responsible for that work, evaluating its quality and for the supervision of all field work.[88]

Attainment of the several objectives of supervision and review indicates the exercise of due care. These objectives include:

1. instructing assistants in various auditing areas and thereby aiding development of their judgmental capabilities through briefing them on the audit plan. Included, for example, are explanations of the client's background, objects of the audit, and implications of parts of the program such as the internal control questionnaire. Specific techniques include going into details and explaining specifically what is to be done, providing assistants diversified experience by rotating their assignments among

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[88]Richard W. Cutting et al., "Technical Proficiency for Auditing Computer Processed Accounting Records," The Journal of Accountancy 132 (October 1971): 78-82.

different clients and different parts of the audit, and encouraging questions.[89]

2. controlling the quality of the work and insuring that assistants comprehend the audit plan and perform the work satisfactorily. This is accomplished through observance and review of the work; review of written reports; allowance of sufficient time for contact with each assistant; adequate explanations of the audit plan, its objectives, and the assistant's role in its implementation; and explanation of the implications of the work and the meaning of due care in the circumstances.[90]

3. obtaining the best use of audit staff through advance scheduling of audits, matching staff requirements with available auditors, having specialists or experts discuss their special areas with the staff, and maintaining the proper chain of authority to facilitate and promote communication between the supervisor and his assistants.[91]

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[89] See King, "What Is On-the-Job Training?" pp. 27-28; W. D. MacDonald, "Staff Training--What Are the CA Firm's Responsibilities?" Canadian Chartered Accountant 93 (October 1968): 280-81; Mautz and Sharaf, The Philosophy of Auditing, p. 138; and Powell, "Audits--Planning and Review," pp. 109-110.

[90] See King, "What Is On-the-Job Training?" pp. 27-28; and Mautz and Sharaf, The Philosophy of Auditing, pp. 138, 208.

[91] MacDonald, "Staff Training--What Are the CA Firm's Responsibilities?" p. 281.

4. establishing that support exists for the work done through complete, systematic, and critical review of working papers; evaluation of services rendered; and review of evidence gathered.[92]

5. conforming to policies existing within the firm and to guides provided by the profession such as the AICPA's review checklist.[93]

Study and Evaluation of Internal Control

The standard of internal control states,

> There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.[94]

Since the study and evaluation of internal control form the basis of further audit examination, the quality of the auditor's work in this area is an important indicator of the exercise of due care in the audit as a whole. Specific indicators of due care from adherence to this field work standard include:

1. matching the degree of competence brought to bear on the audit with the degree of complexity of the internal control system.

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[92]Powell, "Audits--Planning and Review," pp. 118-20.

[93]"Review Checklist for Audits," The Journal of Accountancy 126 (November 1968): 88-90.

[94]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 13.

2. a study or review of the internal control system leading to sufficient knowledge of its strong and weak points for overall evaluation, to the planning of additional necessary tests, to the suggesting of improvements, and to the limiting of reliance on the system. In short, the study of internal control indicates due care if in fact it establishes a basis for the scope of the audit examination and for suggestions of improvement.[95]

3. testing the system of internal control to the extent conclusions are drawn regarding actual compliance with prescribed procedures.[96]

4. placing a degree of reliance on the system which is a logical result of evaluating the system's adequacy and the actual compliance with its procedures.

5. during the audit, reassessing the internal control system for changed conditions, deterioration in compliance, mistakes, management perpetrated errors and irregularities, and collusion circumventing the system.[97]

6. following firm policies in studying, testing, and evaluating internal control.

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[95]Ibid., pp. 14, 33.

[96]Ibid., pp. 23-24, 28-30.

[97]See American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 22; and J. B. Studdy, "A Review of Recent Developments in Auditing Practice," The Chartered Accountant in Australia 39 (September 1968): 247.

7. disclosing the results of the study and evaluation of internal control to the client and the public.

> If he learns of deficiencies in the system of internal control which constitute sources of potential injury to his client, he has an obligation to make these known to the client. Surely no professional man would neglect to inform his client of dangers discovered in the course of serving the client.[98]

In disclosing the internal control weaknesses to the client, due care is indicated by the auditor's being as forceful and emphatic as warranted by the dangers involved and taking into consideration the proper organizational level for such reporting so that deficiencies are not concealed, the proper medium such as a written report, and the timing of the report, especially where the weaknesses are serious in nature.[99] A more difficult area of judgment is disclosure of internal control weaknesses to the public. The major considerations are the materiality of the weaknesses and their influence on the judgment of users of financial statements.

> If the weakness in internal control were such that knowledge of it might deter a reader of the financial statements from taking action which he otherwise would take or would cause him to take an action that he otherwise would not take, it appears that this should be disclosed.[100]

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[98]Mautz and Sharaf, The Philosophy of Auditing, p. 142.

[99]See M. R. Harris, "The Business Approach to the Modern Audit--II," The Accountant 161 (July 19, 1969): 74; and Mautz and Sharaf, The Philosophy of Auditing, pp. 150-51.

[100]Mautz and Sharaf, The Philosophy of Auditing, p. 152.

Since evaluation of internal control is an intermediate step in forming and expressing the opinion, the auditor must consider, in exercising due care, whether he can satisfy himself through other means such as further investigation or gathering evidence from other sources. That is, a weak internal control system in effect limits the scope of the audit so that the auditor must look to an extended examination or other procedures as the basis of the opinion. If he cannot satisfy himself by other means, due care is indicated in the type of opinion rendered--qualified, adverse, or disclaimer. To summarize, due care in evaluating internal control is indicated by disclosing material weaknesses in the system to the public and appropriately qualifying the opinion.

Evidential Matter

> Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.[101]

Indicators of due care from adherence to this standard center on the descriptive terms of quality, "sufficient" and "competent", and on the objective involved, "a reasonable basis for an opinion regarding the financial statements under examination." They include the following:

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[101]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 55.

1. correspondence between the quality of evidence obtained and the evaluation of internal control to the extent the entire evidence available covers material items, unusual conditions, and weak areas or areas having the greatest probability of or susceptibility to irregularity, error, collusion, or circumvention of the internal control system. Due care, in summary, is indicated by the relevance of the evidence to the financial statements under examination.[102]

2. complementarity of the various kinds of evidence obtained, meaning they support or further verify rather than contradict each other, lessen the probability of errors in judgment, and lead to a mental state of knowing or belief concerning the client's financial statements.[103]

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[102] See American Accounting Association, "Report of the Committee on Basic Auditing Concepts," pp. 22, 56; American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 56-57; Robert K. Elliott and John R. Rogers, "Relating Statistical Sampling to Audit Objectives," The Journal of Accountancy 134 (July 1972): 46-55; and Mautz and Sharaf, The Philosophy of Auditing, pp. 78-80, 104-106.

[103] See American Accounting Association, "Report of the Committee on Basic Auditing Concepts," pp. 36-57; American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 101-110; Beedle, "Lessons from the Continental Vending Case," p. 355; D. R. Carmichael, "The BarChris Case--A Landmark Decision on the Auditor's Statutory Liability to Third Parties," The New York Certified Public Accountant 38 (November 1968): 784-85; Robert W. V. Dickerson, "Pacific Acceptance Corporation Limited v. Forsyth et al.," Canadian Chartered Accountant 101 (August 1972): 53; William A. Farlinger, "Atlantic Acceptance--Calamity or Catalyst?" Canadian

3. with the evaluation of internal control, the providing of a reasonable basis for the opinion. In this regard, due care is indicated by reliance on the most compelling evidence reasonably available despite inconveniences in obtaining it or time and cost constraints.[104]

4. timely disclosure of irregularities or suspicions and warnings to the client of possible dangers discovered in the course of acquiring and evaluating evidence. Due care is indicated by foreseeing unreasonable risk of

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Chartered Accountant 98 (May 1971): 342-43; Kenneth S. Gunning, "Letters for Lucy?" Canadian Chartered Accountant 99 (August 1971): 128-34; John R. Hill, "Legal Representation Letters," Canadian Chartered Accountant 100 (January 1972): 19; Mautz and Sharaf, The Philosophy of Auditing, pp. 70, 87-103; Gerald Nash, "Recent Legal Decisions," The Australian Accountant 37 (May 1967): 286; Dennis S. Neier, "Using the Work and Reports of Other Auditors," The New York Certified Public Accountant 41 (October 1971): 721-25; and Studdy, "A Review of Recent Developments in Auditing Practice," pp. 264-65.

[104]See American Accounting Association, "Report of the Committee on Basic Auditing Concepts," pp. 56-57; American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 55-57; D. R. Carmichael, "Arm's-Length Transactions in Accounting and Auditing," The Journal of Accountancy 132 (December 1971): 67-69; Philip B. Chenok, "Clients' Written Representations," The Journal of Accountancy 124 (November 1967): 65-68; Robert W. V. Dickerson, "Pacific Acceptance Corporation Limited v. Forsyth et al.," Canadian Chartered Accountant 101 (September 1972): 63; Kenley, "Legal Decisions Affecting Auditors: Comments on the Pacific Acceptance Corporation Case," pp. 153-61; McLeod, "A Time to Reflect on Our Role," p. 471; Mautz and Sharaf, The Philosophy of Auditing, pp. 68-110; and Stettler, Auditing Principles, pp. 96-108.

harm to others, especially with regard to material or numerous irregularities and situations in which high risk of injury to others exists. It is indicated by prompt disclosures of such conditions to the client at a level appropriate for correction and to the public, particularly in situations such as the Continental Vending case of known dishonesty, looting, diversion of funds, and operation of the company for the benefit of its officers.[105]

Preparation of Working Papers

> Working papers serve as the connecting link between the auditor's field work and his report and, as such, should contain the evidence accumulated in support of the conclusions and recommendations included in the report.[106]

Due care is indicated by and through the working papers related to the engagement. Their preparation in itself is an indication of due care while their content indicates

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[105] See American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 2-4; D. R. Carmichael, "Client Imposed Restrictions on Scope," The Journal of Accountancy 132 (August 1971): 70-71; D. R. Carmichael, "Investigation and Disclosure of Compliance With Laws and Regulations," The Journal of Accountancy 133 (January 1972): 76-77; Robert W. V. Dickerson, "Pacific Acceptance Corporation Limited v. Forsyth et al.," Canadian Chartered Accountant 99 (August 1971): 150; Isbell, "The Continental Vending Case: Lessons for the Profession," pp. 33-40; Albert Lacey and A. Peter Forster, "Auditors and the Law . . . Now, and in the Decade Ahead," The Australian Accountant 41 (May 1971): 179-80; Mautz and Sharaf, The Philosophy of Auditing, pp. 134-40; and United States v. Simon, 425 F. 2d 806 (1969).

[106] U. S., Comptroller General, Standards for Audit of Governmental Organizations, Programs, Activities & Functions, p. 37.

or serves as proof that due care was exercised in the field work.

Regarding the preparation of working papers, due care is indicated by their completeness and accuracy, clarity and understandability, legibility and neatness, and pertinence. Completeness and accuracy refer to proper support for the auditor's findings, conclusions, and recommendations and for demonstrations of the scope of the examination. Clarity and understandability mean the working papers reveal the necessary information in themselves and without supplementary oral explanations so that anyone reading them readily can determine the scope of the examination and conclusions reached. Legibility and neatness refer to an orderly and consistent preparation with proper cross-referencing and supporting schedules. Pertinence means the preparation has been undertaken with a view toward including only matters which are useful and materially important.[107]

Due care is indicated, too, by proper custody and safekeeping of the working papers which prevent improper disclosure of the audit plan to those whose work is under

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[107]Studdy, "A Review of Recent Developments in Auditing Practice," pp. 241-42; and U. S., Comptroller General, Standards for Audit of Governmental Organizations, Programs, Activities & Functions, pp. 37-38.

audit or the incorporation of the working papers as part of or a substitute for the client's records.[108]

Standards of Reporting

The standards of reporting are stated as follows:

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.[109]

These reporting standards outline decisions the auditor must make concerning the fairness of the financial statements under audit. That is, he must decide whether they are presented in accordance with generally accepted accounting principles, whether the principles have been consistently applied, whether adequate disclosure has been made, and whether the statements as a whole are fairly

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[108]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 69-70.

[109]Ibid., p. 5.

presented. In making these decisions, the auditor is faced with solving two different kinds of problems or forming two kinds of judgments--those of fact and those of value. The methodology for each differs, and due care is indicated by the process applied in each case. In forming judgments of fact, the auditor follows a method similar to the scientific method in which emphasis is on the evidence acquired to support the conclusions. For these judgments, which are fairly objective in nature, he determines the evidence needed to support the propositions, gathers that evidence, and then evaluates it to determine the degree of influence it should have on his mind. In forming judgments of value, emphasis is on future consequences involved in following various alternative solutions to the problem at hand. These judgments are highly subjective in nature since they do depend on assessments of the future and since the conclusions are not evaluated in terms of evidence supporting them but in terms of their being logically consistent with other knowledge relevant to the situation as well as compatible with the goals of the audit.[110] In discussing indicators of due

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[110]See John Dewey, Logic--The Theory of Inquiry (New York: Henry Holt and Company, 1938), pp. 487-512; Ray Lepley, ed. Value: A Cooperative Inquiry (New York: Columbia University Press, 1949); Mautz and Sharaf, The Philosophy of Auditing, pp. 18-36; and Eugene J. Meehan, Value Judgment and Social Science (Homewood, Illinois: The Dorsey Press, 1969).

care in each of the reporting decisions, reference will be made to these separate kinds of judgments.

Generally Accepted Accounting Principles

Due care in determining conformance of the financial statements to generally accepted accounting principles is indicated by the auditor's identifying the principles which have been applied by the client, ascertaining their general acceptance, and evaluating their applicability in terms of fairness.

Identifying the principles applied is based on the audit examination and is a problem of fact requiring evidence as support. The auditor has the client's records for review and can consult his working papers in this regard.

The second problem--ascertaining the general acceptability of the principles--is mainly one of value or judgment.

> The determination of whether financial statements are presented in accordance with generally accepted accounting principles requires exercise of judgment as to whether the principles employed in the statements have found general acceptance.[111]

The crux of the problem is that no body of accounting principles has been drawn up officially by the profession as having general acceptance. The auditor can gather

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[111]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, p. 71.

evidence concerning their general acceptance in the form of substantial authoritative support for them.[112] Therefore, due care in forming this judgment is indicated by the existence of such support for the principles. However, in unique or unusual situations in which support does not exist for the principles applied, the auditor must look to the consequences implied in following them. He must follow them to a conclusion and determine what their future effect will be. In such situations, due care is indicated by his reasoning through analogy with similar audit situations or by his concluding that the consequences of applying them logically are consistent with other knowledge of the situation and are compatible with the goals of the audit.[113]

The third decision for the auditor is the applicability of the principles applied to the situation in terms of fairness, even if such principles have found general acceptance. As Mautz and Sharaf note,

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[112]See Marshall S. Armstrong, "Some Thoughts on Substantial Authoritative Support," The Journal of Accountancy 127 (April 1969): 56-60; Paul Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises (New York: American Institute of Certified Public Accountants, Inc., 1965); Mautz and Sharaf, The Philosophy of Auditing, pp. 160-66; and Robert T. Sprouse and Maurice Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprises (New York: American Institute of Certified Public Accountants, 1962).

[113]Mautz and Sharaf, The Philosophy of Auditing, pp. 166-67.

> . . . his evaluation is more than just a comparison of the accountant's work with accepted principles. The auditor must also evaluate the principles and their applicability in the specific existence. . . . Either or both the principles and the accounting may be deficient. . . . Thus the auditor borrows generally accepted accounting principles from accounting but he accepts them with reservations. If they do not meet the needs of the case at hand, he must reject them and develop what in his judgment is a proper solution.
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> . . . rejection is not based on a disinclination to accept practices which others find satisfactory. Rejection is based, rather, on the sober belief that important aspects of the situation at hand remove it from the category to which generally accepted principles do apply. There is something sufficiently unusual about the situation to make generally accepted principles inapplicable.[114]

This decision is in the nature of a value judgment, and the auditor must look to the consequences of applying the principles to come to a conclusion regarding fairness in the situation. Due care is indicated by following their application to a conclusion, determining their future effect on users of the statements, and being concerned with accomplishing the goals of generally accepted principles above following them to the letter.[115] It also is indicated by considering alternative principles which have general acceptance and which may be more applicable to the situation. That is, due care is indicated by bringing into consideration the possible alternatives and selecting that which leads to fairly presented financial statements.

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[114]Ibid., p. 160.

[115]Ibid., pp. 168-69.

Consistency

Due care in determining whether accounting principles have been applied consistently is indicated by the auditor's establishing the fact of consistency or, in situations of inconsistent treatment, the fairness of instituting changes. Due care in establishing the fact of consistency is indicated by the auditor's accumulation of evidence to support it. Given the type of changes which affect consistency, he can examine the client's records for their existence and draw his conclusions from that examination.[116] In situations where changes affecting consistency have been made, the auditor must make value judgments regarding them. Due care in forming these judgments, again, is indicated by his consideration of available alternatives, determination of the fairness of each alternative based on their consequences for uses of the statements, and insistence on selection of the alternative best suited to the situation.[117]

Adequate Disclosure

As with the above two decisions, indicators of due care from determining adequate disclosure depend on the type of judgment made. Determination of the actual

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[116]American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 72-78, 114-21.

[117]Paul Frishkoff, "Consistency in Auditing and APB Opinion No. 20," The Journal of Accountancy 134 (August 1972): 64-70.

disclosures made in the financial statements is a matter of fact, and due care is indicated by the existence of evidence supporting that determination. Evaluating the disclosures in terms of their adequacy is a value judgment. Exercising due care in this evaluation is based on knowledge of the matters which should be disclosed, the proper means of disclosure, and qualities which enhance disclosure. It is indicated by the auditor's using that knowledge, by his considering the full consequences disclosure or nondisclosure has for users of the statements, by his reviewing the available disclosure alternatives, and by his insisting on that disclosure which he concludes fairly presents the information needed by users of the statements.[118]

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[118]See American Accounting Association, Committee on Concepts and Standards Underlying Corporate Financial Statements, "Standards of Disclosure for Published Financial Reports," Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Madison, Wisconsin: American Accounting Association, 1957), pp. 46-50; American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 78-79, 112-14, 123-33; "Auditor's Responsibility to Disclose Information Obtained Subsequent to Publication of Opinion on Financial Statements," The Journal of Accountancy 124 (August 1967): 56-60; Michael N. Chetkovich, "Standards of Disclosure and Their Development," The Journal of Accountancy 100 (December 1955): 48-52; "Continental Vending Decision Affirmed," The Journal of Accountancy 129 (February 1970): 61-69; Robert W. V. Dickerson, "Pacific Acceptance Corporation Limited v. Forsyth et al.," Canadian Chartered Accountant 99 (October 1971): 314-16; and Charles H. Griffin and Thomas H. Williams, "Measuring Adequate Disclosure," The Journal of Accountancy 109 (April 1960): 43-48.

Expression of Opinion

Expression of an opinion depends on results obtained in the examination and on conclusions regarding the fairness of the financial statements which fairness is judged partially according to conformance of the statements to generally accepted accounting principles, consistency in the application of principles, and adequate disclosure. Thus, indicators of due care from expressing an opinion include or reflect on indicators of due care from carrying out the field work and from drawing conclusions regarding fairness. These indicators are evidence the auditor is in a position to express an opinion or disclaim one.

Assuming these background activities to the expression of an opinion have been carried out with due care, the expression itself indicates due care by clearly stating the true opinion, whatever it is, by preventing misinterpretation of the degree of responsibility assumed by the auditor, and by preventing the report's adding unjustified credibility to the financial statements.[119] These indicators are met through the use of graded opinions--unqualified, qualified, adverse, or disclaimer. The basis

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[119] See American Accounting Association, "Report of the Committee on Basic Auditing Concepts, pp. 57, 67-68; American Institute of Certified Public Accountants, Code of Professional Ethics, pp. 20-22; American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 80, 92-93; D. R. Carmichael, The Auditor's Reporting Obligation--The Meaning and Implementation of the Fourth Standard of Reporting (New York: American Institute of

for other than qualified opinions are limitations on the scope of the auditor's examination, lack of fair presentation, and unusual uncertainties.[120] Due care is indicated by the auditor's considering the following in determining the type of opinion to render:

1. relative magnitude, or size, meaning the materiality or dollar impact of an item on the financial statements in terms of the item's significance when compared to some basis of comparison.

2. probability of error in the financial statements or the degree of uncertainty concerning the outcome of some event in terms of the acceptable level of probability, the imminence of the impact from the outcome of the uncertain event on the financial statements, and the evaluation of the uncertainty from past experience.

3. utility of the financial statements when read in conjunction with the audit report which includes the opinion. Assessment of the utility where exceptions are called for in the report involves consideration of the auditor's expertise with respect to the matters calling for the exception, the pervasiveness in the financial

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Certified Public Accountants, Inc., 1972), pp. 1-2; Carmichael, "Client Imposed Restrictions on Scope," pp. 70-71; and Dickerson, "Pacific Acceptance Corporation Limited v. Forsyth et al.," p. 465.

[120] See American Institute of Certified Public Accountants, Statement on Auditing Standards: Codification of Auditing Standards and Procedures, pp. 97-133; and Carmichael, The Auditor's Reporting Obligation, pp. 45, 67-130.

statements of the matters causing the exception, and whether the nature of the item causing the exception is a general condition or a specific matter. Once the auditor has determined the type of opinion to render, due care is indicated by his properly identifying the type of opinion and wording it so as to avoid the appearance of assuming a degree of responsibility he does not intend to assume.[121]

The exercise of due care indicated in reporting means, in effect, the auditor has shown himself to be "as concerned with the fair presentation of his report as he is with the fair presentation of the financial statements of the company reported upon."[122]

Evaluating Due Care

Due care, in a sense, is a state of mind as well as a conclusion regarding the quality of field work and reporting. It is a state of mind in the sense that the auditor himself must be convinced he has exercised due care in making judgments which involve more than applying

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[121]See American Accounting Association, "Standards of Disclosure for Published Financial Reports," pp. 46-50; American Institute of Certified Public Accountants, _Statement on Auditing Standards: Codification of Auditing Standards and Procedures_, pp. 121-23; and Carmichael, _The Auditor's Reporting Obligation_, pp. 22-23, 32-33, 57-109.

[122]Carmichael, _The Auditor's Reporting Obligation_, p. 2.

various audit procedures in field work and following the form of the standard report. The major problem in evaluating the judgments is that the auditor tests his own mind--that is, as with evaluating independence in fact, the process is highly subjective. The contentions here are that the auditor is capable of evaluating his own state of mind, or judgments, in relation to due care and that the standard of due care, as a personal standard, demands this capability.

Tools available to the auditor and applicable in his evaluation of due care are his knowledge of the meaning of due care; indicators of due care including conditions conducive to its exercise; his training and experience in exercising due care in varied audit situations; and his personal abilities such as self-control, self-discipline, and introspection for examining his own work and remaining explicitly conscious of his own activities. Also as with evaluating independence in fact, evaluating due care requires the auditor's ability to avoid self-deception concerning the quality of his work and judgments.

The test of the exercise of due care is its coherence with the known qualities or properties of due care, meaning the actual quality of the auditor's work corresponds to properties known to describe due care. Taking the actual quality of the work and reasoning logically from it should lead to what is known to be due care, and, conversely, taking knowledge of what due care means and reasoning logically from it to the circumstances should lead to the same quality of work found to exist in reality. Since man's knowledge is imperfect, complete coherence between the two is not expected, but an approach to it is. The same idea is reflected in the following definition of truth in auditing.

> In view of the limitations of audit evidence in the establishment of incontrovertible truth and the influence of time and other conditions under which an auditor works, truth in auditing may be defined as conformity with reality as the auditor can determine reality at the time of his examination and with the evidence available.[123]

Having available the tools for evaluating due care and a test of its exercise, the auditor can evaluate it through a process of introspection or reflection, either looking at the situation and judging what due care means before exercising it or reviewing his work and judgments in terms of due care before rendering his opinion. Both methods essentially involve the same mental activities. However, the process of evaluating due care varies with the type of judgments being evaluated. As discussed in relation to indicators of due care through adherence to the reporting standards, basically two kinds of judgments are made--those related to problems of fact in which the emphasis is on evidence and those related to problems of value in which the emphasis is on future consequences

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[123]Mautz and Sharaf, The Philosophy of Auditing, p. 110.

involved in the decision. The auditor relies on a process of introspection or reflection because he cannot test his work in the same sense as a scientist does. He cannot control the conditions or rely on exactly similar situations. In addition, he usually must form judgments on less than the best evidence, depending on that available in the engagement.[124]

In evaluating the exercise of due care in relation to problems of fact, the auditor must consider the available evidence in terms of its qualities and its degree of influence on the mind as well as whether his judgments follow logically from that evidence. Qualities he should look for include, for example, the reliability of the evidence, its corroboration of other evidence or at least lack of conflicting evidence, and its consistency in relation to other information. Influence on the mind refers to the persuasiveness of the evidence in removing doubt, and in this regard, the auditor should consider implications of all the evidence taken together rather than looking only to each piece of evidence in isolation. Finally, the auditor must determine whether his judgments follow logically from the evidence he has and whether the evidence he has supports those judgments made.

In evaluating the exercise of due care in relation to value judgments, the auditor must judge whether all

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[124]Ibid., pp. 30-31.

available alternatives have been considered. For those selected, he must determine whether their consequences give priority to the public's interest and are consistent with goals of the audit such as fair presentation.

Summary and Conclusion

Adherence to the standard of due care means the auditor has the ability to evaluate his own work and judgments. That is, he can analyze the quality of his work in terms of due care before rendering his opinion rather than depending on a conclusion of due care should his work be challenged in a court of law. The important part in adhering to due care is to approach the audit with the intent of exercising it rather than performing the audit and looking back to determine whether it was exercised. For this evaluation or analysis of due care, the auditor relies on knowledge of the meaning of due care, on indicators due care has been exercised, and on the ability to be objective in evaluating his own work. Guidelines for adherence to the standard of due care thus include these points and have as their objective a means of analyzing the exercise of care before an opinion is rendered.

CHAPTER VII

SUMMARY AND CONCLUSIONS

Summary

The dissertation has as its purpose a clearer understanding than now exists of the general standards of auditing. The means for accomplishing this purpose are guidelines for adherence to the standards. Need for such guidelines stems from the fact that the standards themselves are very broadly stated--"they do not go far enough in fulfilling their purpose"[1]--while auditing procedures, the other extreme of the spectrum, relate to particular situations and audit techniques. Although the standards do not change, the meaning of adherence to them does as new situations arise or as conditions within the auditing environment change. While institutions such as the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the legal profession, and the Securities and Exchange Commission as well as individuals give interpretations to the standards

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[1]R. K. Mautz, "A Critical Look at Generally Accepted Auditing Standards," <u>Proceedings of the Twentieth Annual Institute on Accounting</u> (Ohio: The Ohio State University Bureau of Business Research, 1958), p. 21.

reflecting changed conditions, these interpretations generally are procedural in nature and apply to specific situations. For this reason, the auditor needs guidelines for continually interpreting and evaluating his own compliance with the standards--guidelines which can be used in varied auditing situations and under varied conditions.

The general standards to which the guidelines apply are adequate technical training and proficiency as an auditor, independence in mental attitude, and due professional care. All three are necessary for the rendering of an unbiased opinion, deriving from the auditor's ethical and legal responsibilities to third parties who cannot judge for themselves the fairness of the financial statements and who therefore rely on his examination and professional opinion. The standards are interrelated in that due professional care is the application of adequate technical training and proficiency to the audit examination and reporting while independence in mental attitude adds assurance of control over bias in published financial statements.[2] In addition to being interrelated, the standards are characterized as being personal in nature, referring to "the qualifications of the auditor and the

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[2]American Accounting Association, Committee on Basic Auditing Concepts, "Report of the Committee on Basic Auditing Concepts," The Accounting Review 47 (Supplement 1972): 8.

quality of his work."[3] As such, they require the auditor's personal evaluation of his adherence to them before he undertakes an engagement or before he renders an opinion.

Guidelines for adherence to the general standards of auditing are constructed around the meaning, indicators, and evaluation of adherence to the standards. The rationale for this approach lies with the need for understanding the meaning of the standards in order to comply with them, for having some type of evidence of such compliance, and for having available a process of evaluation by which to judge the extent of compliance. While emphasis is on the process of evaluation, the meaning and indicators of adherence to the standards are necessary before the evaluation can be applied effectively.

Adequate technical training and proficiency as an auditor means current and continually improving knowledge, skills, and abilities relevant to auditing and of a quality at least equal to that possessed by the average practitioner of good professional standing. This competence is acquired from formal education, training and experience, and continuing professional education. The ultimate test of competence lies in its application, but

[3]American Institute of Certified Public Accountants, Committee on Auditing Procedure, Statement on Auditing Standards: Codification of Auditing Standards and Procedures (New York: American Institute of Certified Public Accountants, Inc., 1973), p. 7.

indicators of it are (1) possession of the minimum knowledge necessary for entry into the profession demonstrated by attaining a level of formal education consistent with that expected of professional auditors and by passing the CPA examination, (2) training and varied experience as an auditor, (3) performance as an auditor demonstrated by successfully applying skills and abilities to audit assignments and by firm advancement, and (4) exposure to continuing professional education.

Independence in mental attitude means appearing to be free of any obligation to or interest in the client, being self-reliant in forming judgments or opinions and in accepting responsibilities, and being intellectually honest--that is, being free from bias with respect to the client under audit, avoiding self-deception with regard to the state of mind, and cultivating attitudes to prevent falling into biases or using defense mechanisms which lead to self-deception. Indicators that independence has been maintained are (1) lack of relationships between the auditor and client which are proscribed by the profession; (2) existence of programming, investigative, and reporting freedom; (3) organizational neutrality within the audit firm and its support of independence; (4) support for independence from the profession and institutions such as the Securities and Exchange Commission; (5) the auditor's demonstration of self-reliance in forming judgments, carrying out field work, and reporting audit results; (6) the auditor's attitudes of open-mindedness and undivided interest in his work; (7) the presence of clearly formed ideas about independence, ethics, and fairness; (8) the auditor's sense and acceptance of responsibilities, especially to third parties; and (9) his development of intellectual abilities to judge his own state of mind.

Due professional care means competently observing the standards of field work and reporting, not knowingly misrepresenting facts or subordinating judgment to others, due diligence in the investigation as defined under the Securities Act of 1933, acting in good faith and without conscious misrepresentation as defined under the Securities Exchange Act of 1934, skillfully carrying out terms of a contract so as not to invade any right created by it, and the absence of negligence. Indicators of due professional care are (1) compliance with provisions of relevant statutes and with contract terms, (2) exercising in the audit the minimum knowledge and skill commonly possessed by professional auditors as well as any special skill possessed above the minimum, (3) anticipating and guarding against reasonably foreseeable risks of injury involved in audit activities, (4) avoiding behavior involving unreasonable risk of danger to others, (5) conforming to reasonable standards of conduct customary of the profession, (6) anticipating emergencies, and (7) adhering to the standards of field work and reporting.

The process of evaluating adherence to the standards is a testing of the congruence of the known properties of the standards with the real or truthful facts of the auditor's qualifications, his state of mind, and the content and quality of his work. Activities involved in this testing or evaluation include gathering evidence in the form of indicators of adherence to the standards, considering the combined as well as individual effects of existing conditions on adherence to the standards, comparing the actual situation with the meaning and indicators of adherence to the standards, considering the full consequences of alternative courses of action available as well as those followed in the circumstances, and arriving at a mental state of belief regarding adherence to the standards. The process may be described as introspection--"observation and contemplation of one's own mental process, and experiences; systematic self-observation"[4]--and as involving reflection--"the kind of thinking that consists in turning a subject over in the mind and giving it serious and consecutive consideration."[5]

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[4]Benjamin B. Wolman, ed., Dictionary of Behavioral Science (New York: Van Nostrand Reinhold Company, 1973), p. 202.

[5]John Dewey, How We Think (Boston: D. C. Heath and Company, 1933), p. 3.

Conclusions

Conclusions drawn from this dissertation concern attainment of its purposes, the process of evaluating adherence to the standards, and ideas for further research.

Purpose of the Dissertation

The purpose of the dissertation--a clearer understanding than now exists of the general standards of auditing--has been accomplished through the development of guidelines for adherence to the standards. These guidelines bring together ideas, from accounting literature, of the meaning and indicators of adherence to the standards and add, from behavioral sciences, thoughts relevant to a process of evaluating that adherence. Since the standards are personal in nature and require the auditor's evaluation of his own compliance with them, the guidelines primarily are useful and intended as a means of personal evaluation through introspection or reflection.

While the ideal situation in any discipline is a perfect system of knowledge with regard to it, the conclusion here is that, in reality, less must be accepted and the ideal only approached in the limited time of an audit and given the limited knowledge available to any one auditor. Also, the knowledge applicable to the discipline changes over time meaning that a perfect or ideal state is not attainable once and for all. Guidelines for adherence to the general standards of auditing, then, must correspond to changes in the auditing profession, reflecting new ideas concerning the meaning and indicators of adherence. As knowledge of thought processes improves or increases, that knowledge must be added to the process of evaluation applied by the auditor in testing his adherence to standards.

The guidelines are not as broad in scope as are the general standards themselves, yet they also are not procedural in the sense of applying to particular audit situations. They offer, instead, a means of testing the degree of coherence between the known properties of the standards and their actual implementation. While not intended as the last word on adherence to the general standards of auditing, they do present a clearer understanding of them as well as a pattern for further increasing that understanding. They outline areas about which the auditor should be continually aware and should attempt to improve his knowledge and skills.

Evaluation of Adherence to the Standards

The process of evaluating adherence to the standards is the same for all standards and involves the same test of coherence. However, this process is most importantly applied to the evaluation of independence in fact because the auditor is the only one who can know or determine his state of mind. Independence in appearance, competence, and due care are evaluated by others as well as by the auditor. Their evaluation, in effect, serves as a check or balance against his.

The ultimate test of adherence to the general standards of auditing lies in their application to field work and reporting activities, but the aim of the standards is not evaluation of adherence after an audit has been undertaken or after an opinion rendered. Rather, the aim is an evaluation before others have opportunity to rely on the auditor's work and opinion. Such an evaluation beforehand is in the nature of a value judgment with emphasis on future consequences involved in alternative courses of action. The evaluation accordingly has the same limitations as do value judgments--limitations which are observable in the following descriptions of value judgments taken from Eugene J. Meehan's <u>Value Judgment and Social Science</u>.

> . . . a value judgment is defined as a choice among alternative outcomes, a selection of one outcome in preference to another in a given situation, or the application of a set of values to an empirical situation.
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> If choices are judged by their consequences, value judgment requires calculations that extend into the future.
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> . . . .
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> Value judgments must lie within, and make use of, the capacity of human actors.
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> Value judgments refer to genuine empirical situations. . . . Every observable situation in some sense lies outside the observer's control. . . .
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> . . . .

> A piecemeal approach to the development of ethics is unavoidable. . . . The search for universal rules of evaluation, unaffected by time or place, is as futile as the search for a universal map that can perform the function of all possible maps for all possible map users.
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> . . . .
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> Value judgments are absolutely contingent upon descriptions and explanations.
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> Clearly, the limits of man's capacity for explanation are a significant constraint on his ability to act or choose rationally. . . .
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>
> In social science, explanation and evaluation are likely to remain faulty and imperfect and unreliable for a very long time.
>
> . . . .
>
> Since value judgments are made in concrete situations, there are always constraints and limitations on choice that the actor cannot avoid. Perhaps the most significant of these limits are the consequences of scarcity. The resources that man must have to pursue his individual and social goals, material and nonmaterial, are in many and even most cases in short supply.[6]

From this description of value judgments, the conclusion regarding the process of evaluating adherence to the general standards is that the process is limited because it is based on future events or outcomes, relates to empirical situations conditions of which may lie outside the auditor's control, lacks absolutism, depends on imperfect explanations and descriptions, is subject to human fallacies, and has limited resources for judgment formation. The process is limited further because an exact description of how a person does or should think cannot

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[6]Eugene J. Meehan, Value Judgment and Social Science (Homewood, Illinois: The Dorsey Press, 1969), chs. 2, 3, 5.

be given. Rather than providing cause to abandon attempts at value judgment formation or evaluation of adherence to standards, the limitations, especially those of scarce resources, indicate areas needing further research, and they also are the very reason for the necessity of value judgments.

> Man lives in a world of limited resources and limited possibilities; such limits make value judgment necessary.
> . . . .
> No amount of technological or scientific advance will alter the situation very much; scarcity, which supplies the rationale for the search for a reasoned basis for choice, cannot be eliminated. If all resources were in all cases available in unlimited amounts (unthinkable because of such things as time and energy which are finite and nonextensible), there would be no need for value judgments of the kind discussed here--no choices would have to be made.[7]

Further Research

Ideas for further research suggested by the dissertation relate to the overall field of auditing, especially to auditing philosophy, and to each of the general standards of auditing.

Field of Auditing

In the field of auditing, further research is needed to disclose the importance and effect of other disciplines on auditing development. Auditing most obviously borrows from accounting, but it also is related to and borrows from other fields of study. For example, in this

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[7]Ibid., pp. 61, 130.

dissertation, auditing has been related to the field of education in the case of competence, philosophy and logic most notably in the case of independence, and law in the case of due care. Research into the influences of these disciplines, an institutional approach to auditing, would add to the understanding of auditing as it presently exists in theory and in practice. It also would add to analyses of the future direction of auditing by indicating the sources from which changes are likely to be initiated. This institutional approach is not suggested as a complete description of auditing in itself but rather as one aspect of such a description. Other approaches such as conceptual and procedural ones equally have their place in understanding auditing.

In this same vein, the dissertation suggests further research is needed to disclose the relevance of behavioral science for auditing. The process of evaluating adherence to the standards emphasized in the dissertation depends on the auditor's understanding of his own behavior, state of mind, motives, and defenses--concepts usually not emphasized in auditing literature or auditing education. Besides this application of behavioral science to auditing, it has relevance to other auditing aspects such as supervising assistants, managing an audit firm, auditor-client relationships, and the effect of audit reports on users of the information. Since the entire audit process revolves around people, from the auditor and his associates to the client's employees and managers and third parties, the advances made in behavioral sciences should be given consideration and studied for possible application to auditing.

One aspect of the application of behavioral science ideas to auditing already presented in the conclusion is the area of value judgments. Value judgments not only constitute the heart of the process of evaluating adherence to the standards; they also are involved in other auditing decisions such as evaluating adequate disclosure, determining the applicability of accounting principles employed by the client, and judging the fairness of financial statement presentation. Because value judgments pervade many auditing decisions and ability to form them distinguishes the professional from the technician, further research into the process and methodology of forming value judgments in auditing is justified. Ideas for such further research include greater understanding of the tools needed for the process, of the priorities to be assigned to variables in the situation, and of the means for testing the consequences of value judgments. Tools used in forming value judgments are the factual and normative components employed.

> The factual component of judgment includes all of the structures, processes, and observations needed to specify the set of outcomes from which human choice is made; analytically, it consists of descriptions,

> explanations, and perhaps forecasts. The strictly normative component of value judgment comprises the standards or principles used to judge outcomes and the calculations needed to apply those standards to a specific situation.[8]

A crucial problem in value judgments is assignment of priorities to variables in a situation so that reasoned choices can be made regarding alternative courses of action having different consequences. As brought out earlier, value judgments involve choices having alternative future consequences, and the auditor must consider those consequences of his actions. Here, further research should be directed to determining variables relevant to auditing judgments and the priorities to be assigned them.[9] As John Dewey pointed out, the need is for intellectual direction of actions.

> We have obtained in constantly accelerated measure in the last few centuries a large amount of sound beliefs regarding the world in which we live; we have ascertained much that is new and striking about life and man. On the other hand, men have desires and affections, hopes and fears, purposes and intentions which influence the most important actions performed. These need intellectual direction.[10]

Rather than rigid rules for adherence to standards, auditing needs further research into the development of means to disclose and test factual consequences of actions undertaken to carry out the purposes of the standards.

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[8]Meehan, Value Judgment and Social Science, p. 54.

[9]Ibid., pp. 104-107.

[10]John Dewey, The Quest for Certainty (New York: G. P. Putnam's Sons, 1929), p. 71.

> A moral law, like a law in physics, is not something to swear by and stick to at all hazards; it is a formula of the way to respond when specified conditions present themselves. Its soundness and pertinence are tested by what happens when it is acted upon. . . . The idea that adherence to standards external to experienced objects is the only alternative to confusion and lawlessness was once held in science. But knowledge became steadily progressive when it was abandoned, and clews and tests found within concrete acts and objects were employed. The test of consequences is more exacting than that afforded by fixed general rules. In addition, it secures constant development. . . .[11]

The General Standards

For each of the general standards of auditing, ideas for further research include efforts which the profession itself can make to enhance understanding of and adherence to the standards. The dissertation examined the individual auditor's adherence to his personal standards, not efforts which the profession and other institutions could take to facilitate such adherence or to remove obstacles and unfavorable conditions they cause. Research would include identifying possible efforts and judging them according to criteria such as desirability, feasibility, ease of implementation, benefit, cost, and time. An example of the type of effort under consideration here is the desirability of the profession's control of education through accreditation. As Casler noted,

> In contrast with the medical and legal professions, the public accounting profession has no accrediting process by which it can control the number, location,

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[11]Ibid., p. 278.

> and curriculum of the colleges and universities which are now becoming the typical method of gaining entry to the profession. Although the profession partially controls access on a technological basis by means of the licensing system for certified public accountants, it has not yet extended its control to the idealogic training which is a function of accredited professional schools.[12]

The most important question to be examined by further research is the desirability of such efforts. Involved, too, is the question of establishing professional schools of accountancy and auditing for academic preparation of auditors to enter practice. In The Higher Learning in America, Thorstein Veblen discussed the different roles and purposes of universities of higher learning and professional schools and concluded that the two should not be intimately associated.[13] In distinguishing the two, he noted,

> University teaching, having a particular and special purpose--the pursuit of knowledge--it has also a particular and special character, such as to differentiate it from other teaching and at the same time leave it relatively ineffective for other purposes. Its aim is to equip the student for the work of inquiry, not to give him facility in that conduct of affairs that turns such knowledge to "practical account."
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> All of this, of course, implies no undervaluing of the work of those men who aim to prepare the youth for citizenship and a practical career. It is only a question of distinguishing between things that belong

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[12] Darwin J. Casler, The Evolution of CPA Ethics: A Profile of Professionalization (East Lansing, Michigan: Michigan State University, 1964), p. 118.

[13] Thorstein Veblen, The Higher Learning in America (New York: B. W. Huebsch, Inc., 1918; reprint ed., New York: Sagamore Press Inc., 1957).

> apart. The scientist and the scholar on the one hand, and the schoolmaster on the other hand, both belong within the later growth of civilization; but a differentiation of the two classes, and a division of their work, is indispensable if they are to do their work as it should be done, and as the modern community thoughtfully intends that it should be done.
>
> . . . .
>
> In aim and animus the technical and professional schools are "practical," in the most thoroughgoing manner; while the pursuit of knowledge that occupies the scientists and scholars is not "practical" in the slightest degree. The divergent lines of interest to be taken care of by the professional schools and the university, respectively, are as widely out of touch as may well be within the general field of human knowledge.[14]

As illustrated in the following remarks, Veblen recognized the bond between the two.

> But with all this divergence of purpose and animus there is after all a broad and very substantial bond of community between the technical schools, on the one hand, and the proper work of the university, on the other hand, in that the two are, in great measure, occupied with the same general range of materials and employ somewhat the same logical methods in handling these materials.[15]

However, he concluded that inclusion of professional schools within a university of higher learning would be detrimental to both.

> Neither to the man engaged in university work nor to the technical schools that may serve him as occasional sources of material is there any advantage to be derived from their inclusion in the university establishment. Indeed, it is a detriment to both parties, as has already been remarked, but more decidedly to the university man.[16]

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[14]Ibid., pp. 12-14, 19-20.

[15]Ibid., p. 20.

[16]Ibid., pp. 21-22.

Veblen continued with reasons for his conclusion, but the point being made here is that serious consideration should be given to ideas such as these before answering the questions of whether the profession should control the auditor's education acquired in universities of higher learning and whether professional schools for auditors should be established to prepare them for practice.

Other topics for further research pertain to individual standards. Regarding competence, more research is needed in the area of continuing professional education, including, for example, more definitive guides for determining the direction it should take; the defining of areas of responsibility to be assumed by the individual, universities, public accounting firms, and the profession; and determination of the degree and kind of control the profession should exercise over it.

In the area of independence, Mautz and Sharaf suggested dual, and potentially conflicting, roles for auditors in the development of accounting principles.

> We must recognize, of course, that many auditors also act as accountants, and that as accountants they may have had a hand in developing the generally accepted principles of accounting they now use as a guide in auditing. Nevertheless, there is a clear line between auditing and accounting activities. . . .[17]

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[17]Mautz and Sharaf, The Philosophy of Auditing, p. 48.

One example of a potential conflict is the auditor's placing third parties' interests above those of influential clients in developing the principles. The formation of the Financial Accounting Standards Board is an attempt to recognize "the need for a separate and independent group to research and establish financial accounting standards" and involve other members of the financial community in the development and interpretation of accounting principles.[18] Ideas for further research concerning independence include the actual effect of this separate group on accounting principles and the implications for auditors' independence.

Another aspect of independence calling for further research is the auditor's or the public accounting firm's performance of management advisory or other nonauditing services for audit clients. While many articles, both pro and con, have been written on the topic and some empirical research undertaken, a potential conflict of interest between the two areas remains. Research should be directed to determining how the auditor's state of mind may be influenced by performance of nonauditing services as well as to possible solutions of the conflict of interests involved. These solutions may include, for example, ways to achieve organizational neutrality within

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[18] James W. Patillo, "Unity in the Accounting Profession," The Journal of Accountancy 138 (July 1974): 51-53.

the public accounting firm and efforts the individual can make to maintain his independence in mental attitude.

The dissertation and recent developments within the auditing profession suggest two ideas for further research regarding due care. These are a clearer understanding and definition of the auditor's responsibility for fraud detection and a clearer meaning of exercising due care in the audit of electronic data processing systems. The most notable development within the profession involving both areas is the Equity Funding scandal centering around fraud perpetrated through use of the computer.[19] SEC Commissioner A. A. Sommer, Jr. illustrates the need for more clearly defining responsibility for fraud detection and the relationship of fraud to accounting in the following remarks:

> We know, as you know, that a really successful fraud or failure to provide full and fair information can scarcely be accomplished in our complex financial world without the help of accountants and lawyers.
>
> This help may be active and intentional connivance, or it may be more passive and subtle, but it is frequently essential.[20]

In addition to a clearer definition of responsibility for fraud detection, further research might include

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[19]See Frederick Andrews, "SEC Jolting Auditors Into a Broader Role in Fraud Detection," The Wall Street Journal, 12 July 1974, pp. 1, 16; and John C. Burton, "The SEC and the World of Accounting in 1974," The Journal of Accountancy 138 (July 1974): 59-60.

[20]"Limitation on Auditor's Liability Suggested," The Journal of Accountancy 138 (July 1974): 21.

identifying indicators of fraud or the most prevalent means of perpetrating it, developing audit techniques for detecting fraud, and describing the knowledge and skills, or competence, necessary for detecting fraud or errors, particularly that needed for auditing electronic data processing systems in which fraud or errors may occur and remain undetected using current auditing techniques.

These ideas for further research emphasize the need to look to other fields of study, particularly the behavioral sciences, for increased understanding of the processes involved in forming value judgments and in personally evaluating adherence to the general standards of auditing. Ideas such as those presented for further research in the area of due care are intended as efforts to increase understanding of the meaning of the standards, thus adding to the tools available to the auditor for judging his degree of adherence to them.

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