

P A R T I

INTRODUCTION AND SOCIETY'S EXPECTATIONS OF
THE ACCOUNTANCY PROFESSION



CHAPTER 1

INTRODUCTION

1.1 The Aims of this Study

There has been an abundance of literature about the so-called explosion of knowledge and the anticipated accelerated rate of growth in the body of knowledge within the next decade or so. It has been anticipated that the general body of knowledge may be expected to double every five years. In the accountancy field it has been stated that the growth has been in expectations and not in knowledge. How will this growth of expectations and to a certain extent of knowledge affect accountancy in South Africa in general and accountancy education in particular?

During the last few years it has been contended that accountancy education in South Africa has been too technique-oriented with insufficient emphasis on the underlying philosophies and theory. At universities a different approach to the teaching of accountancy has caused accountancy education to become very controversial, but this is believed to be beneficial as now both the academics and the profession are thinking about the approach. It has further been contended that the technique-oriented approach, which is followed at many South African universities, is the result of the influence of the Final Qualifying Examination of the Public Accountants' and Auditors' Board.

The aim of this study is to review developments in accountancy education overseas, to see how these could be applied to South African accountancy education and to make recommendations which could possibly lead to improving accountancy education in South Africa. The structure of the profession in South Africa is reviewed, and recommendations are made where it is felt that the structure affects education.

1.2. Definition of Terms

The term *Accountancy* is defined by Kohler as being:

"The theory and practice of accounting: its responsibilities, standards, conventions, and activities generally; ... see accounting." 1)

The definition of *Accounting* is a problematical one. In an official policy statement of the American Institute of Certified Public Accountants this definition is given:

"Accounting is a discipline which provides financial and other information essential to the efficient conduct and evaluation of the activities of any organisation.

The information which accounting provides is essential for (1) effective planning, control and decision making by management, and (2) discharging the accountability of organisations to investors, creditors, government agencies, taxing authorities, association members, contributors to welfare institutions and others.

Accounting includes the development and analysis of data, the testing of their validity and relevance, and the interpretation and communication of the resulting information to intended users. The data may be expressed in monetary or other quantitative terms, or in symbolic or verbal forms." 2)

It is interesting to observe that in one of the most authoritative works on the common body of knowledge for accountants, *Horizons for a Profession*, there is no endeavour to define the term *Accounting*.³⁾ This is the reason given:

"Because accounting interrelates with other disciplines it is not readily subject to isolation from its environment. ... With the many and continuous changes that have already taken place in the accounting field over the years, the borrowing from other

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- 1) Kohler, Eric L., *A Dictionary for Accountants*, Prentice Hall, Fifth edition, 1975, pp.6/7
 - 2) AICPA Planning Committee, "A Discription of the Professional Practice of Certified Public Accountants", *The Journal of Accountancy*, December 1966, as reproduced in *Report of the Committee on Education and Experience Requirements for CPAs*, American Institute of Certified Public Accountants, New York, March 1969, p.20.
 - 3) Roy, Robert H. and MacNeill, James H., *Horizons for a Profession*, American Institute of Certified Public Accountants, New York, 1967, p.193.

disciplines, the changes in methodologies, etc., it is not only difficult, but undesirable to attempt to compartmentalize all accounting knowledge per se. Rather, this prescription for accounting should be thought of as an integral part of the total common body of knowledge." ⁴⁾

What is *Education*? Webster's Dictionary defines *Education* as:

"The process of educating; systematic training and development of the intellectual and moral faculties; the result of a systematic course of training and instruction."

It will be observed that the definition includes training. In this study the practical-experience requirements of the accountancy profession throughout the world are examined and practical experience is regarded as being complementary to formal education. There are valid criticisms against a practical-experience requirement and these are investigated in some detail. Education is viewed in the long-term, that is, pre-qualification as well as post-qualification is examined. It is necessary to determine whether the qualified accountant should continue his education as a mandatory requirement for reregistration as a practising accountant every few years.

1.3 Scope of Study

The study reviews pre-qualification and post-qualification education including practical-experience requirements and required continuing education. However, prior to defining the educational needs of the future chartered accountant, it is necessary to investigate what society will expect of the accountancy profession. This is based on the premise that if greater expectations will be made of the accountancy profession, a broader education, which will enable the future accountant to teach himself, is important. After investigating society's expectations the educational policies throughout the world are examined to determine the salient

4) *Loc. Cit.*

features of the various accounting institutes' policies. The profession in South Africa is examined in some detail with a review of the history as well as an in-depth study of the structure of the controlling bodies in this country. The role of the universities in accountancy education in South Africa is examined, as well as the influence of the Final Qualifying Examination of the Public Accountants' and Auditors' Board on the teaching of accountancy at various universities.

The philosophies of accountancy education are reviewed to determine what is relevant to South African accountancy education. Recommendations made in various chapters are summarised at the end of the study. It is not the aim of the study to define a detailed common body of knowledge, but rather to give broad outlines which the universities could use as guidelines for minimum requirements. This should not have a stultifying effect because the details are left to the universities and they can decide in what depth lectures on the various topics should be given. Certain core areas are required though.

1.4 Methods of Research

Accounting institutes throughout the world were visited to determine their views on various aspects of accountancy education. In various countries, namely Australia, New Zealand, United States of America, Canada, Scotland, England, Holland and Germany, as many universities as possible were visited. Their approach to the accountancy profession and accountancy education was also investigated. Chartered accountants in South Africa, both in and out of public practice, as well as academics were interviewed about their opinions on accountancy education in general. An in-depth study of available literature has also been made.

A questionnaire was designed, tested and sent to all chartered accountants in South Africa. The questionnaire endeavoured to test the opinions on the various aspects of

accountancy education and the practical-experience requirements. However, certain reservations are expressed about the questionnaire, as possibly not all chartered accountants have the necessary background to express a well-reasoned answer. The satisfactory response to the questionnaire does indicate that accountancy education in South Africa is causing its fair share of controversy and it is assumed that those chartered accountants who completed the form are interested in the subject. The question that arises is why the questionnaire was sent to all chartered accountants instead of reliance being placed on a random sample. The reason for this is that a similar survey was done in 1968 and although those results are not truly comparable with the present results, certain comparisons can be made. Some of the questions utilised in the questionnaire in Annexure A are similar to those used in the 1968 survey, and Section E of the questionnaire is based on a similar survey done in the United Kingdom.⁵⁾ When this part of the questionnaire was tested the observation was made that there were too many topics, and this comment has proved to be true because of the large number of questions rejected in this particular part. The frequency responses to most questions in the questionnaire have been exposed to a chi-squared (χ^2) test to prove the significance of certain hypotheses.⁶⁾

Certain provinces objected to the circulation of the questionnaire and it was decided to send out a covering letter different from the one originally designed. The questionnaires sent to the Transvaal had the original letter and those sent to the other provinces had the different one. Both covering letters are included in Annexure A. Because of the difference in the covering letters, in a comparative summary in which the statistical frequencies have been exposed to a chi-squared test, the percentages of "no responses" are indicated for the various provinces. It will be noted that in most instances the percentages of "no

5) Solomons, David and Berridge, T.M., *Prospectus for a Profession - The Report of the Long-Range Enquiry into Education and Training for the Accountancy Profession*, London, Gee & Co., Limited, 1974.

6) For a brief discussion of Chi Squared tests see pp.267/269 and for the schedule indicating the relevant significance of the results see Annexure C.

responses" are higher in the other provinces than in the Transvaal, but not materially so and it is felt that this does not effect the validity of the survey.

The responses to the questionnaire are, it is stated, representative of the profession in South Africa, because the spread between the various occupations appears to have a very close correlation with the estimated situation in South Africa. No accurate statistics are available, but it is estimated that approximately forty percent of chartered accountants are in public practice. The geographical spread of the respondents is very similar to the actual geographical spread in South Africa, with the exception of a slight bias towards the Transvaal and slightly disappointing responses from the Cape Province. This may be because of the controversy referred to above, or because the questionnaires went out late to the other provinces or because the return date on the questionnaire was different from the one in the covering letter.

It is to be observed that the recommendations are based on what is felt to be best for the profession as a whole and have not necessarily been based on the responses to the questionnaire only.

1.5 Importance of Findings

It is acknowledged that changes in education for professions such as accountancy, do come about very slowly because of vested interests of members of the profession. If the recommendations made in this study will serve as a catalyst for further discussion within the profession and between the profession and university academics, and if they will lead to essential changes within the profession and at the universities, in an evolutionary way, this study will have been justified.

CHAPTER 2

SOCIETY'S EXPECTATIONS OF THE ACCOUNTANCY PROFESSION

2.1 Introduction

It is of the utmost importance to endeavour to assess the possible responsibilities of the profession in future, so that the future accountant can be given the necessary education to meet these challenges. The accounting profession generally accepts change very reluctantly, and this reluctance can possibly be understood when the legal responsibilities of the profession are taken into account. It is fair to assert that the accounting discipline has also been swept by the winds of change and has also had to contend with an avalanche of knowledge. Reference to the "explosion of knowledge" has often been made, which certain authorities describe rather as an "explosion of expectations" with regard to the accounting profession.

The development of man has been revolutionary during the last two decades and many of the developments could not have been contemplated during the early fifties. Needless to state that the information disciplines will be expected to rapidly follow suit in its development. In the past the accountancy profession was expected to extend its functions and it can safely be stated, without fear of contradiction, that these expectations will be maintained in future. The social environment is continuously changing and the social responsibilities of the accountancy profession will no doubt be greater in future. The profession in South Africa will have a very important role to fulfil in the long term development of the Bantu Homelands. It is fair to assume that corporations will be expected to give greater accountability in future. This accountability will also refer to such aspects as environmental controls, pollution controls, what is being done for its labour force and its contributions to society in general.

If the accountancy profession is to make a meaningful contribution to the development of society in future, it is necessary for it to strive to improve the quality of the information being users. The attest

function will remain important only as long as the credibility of the profession is beyond reproach and the information that is being attested is useful. Much of the present literature is devoted to means of improving accounting information. During these times of rampant double-digit inflation the limitations of financial statements based on historical costs have been proved beyond doubt. The various alternatives open to the profession have to be investigated.

2.2 Futurism

The accountancy profession will have to make changes and not wait for legislation to force it to accept greater responsibility. Various studies have been made in which the future of the accountancy profession has been discussed. This interest in the future is known as "futurism". In their book, *"The Accounting Profession"*, the Buckleys refer to the two conceptual approaches of futurism: teleologically and ontologically. The former is based on destiny, fatalism or predestination, which implies that the accounting function is shaped by forces basically beyond its control. The ontological view is that:

" ... invention and innovation are visible manifestations of a self-generating process or an institution having a dynamism and life of its own." 1)

The Buckleys believe that both the external and intrinsic forces combine to make institutions more compatible with their environments and that this compromise position is the way in which the accounting profession appears to relate to the future.

The future has been anticipated in numerous studies and the most notable is possibly John L. Carey's, *"The CPA Plans for the Future"*.²⁾ (This is the report of the Committee

1) Ayres, Robert U., *Technological Forecasting*, McGraw-Hill, New York, 1969, pp.29/30., as quoted in Buckley John W., and Buckley Marlene H., *"The Accounting Profession"*, Mellville Publishing Company, Los Angeles, 1974, pp.134/135.

2) Carey, John L., *"The CPA Plans for the Future"*, American Institute of Certified Public Accountants, New York, 1965.

on Long-Range Objectives of the American Institute of Certified Public Accountants under the chairmanship of the late Robert M. Trueblood.) The book analyses social and economic changes, implications of automation, internationalism, the scope of accounting practice, the future structure and education of the profession. Subsequent to this, Charles T. Horngren endeavoured to describe the profession in 1999. The article entitled "*The Accounting Discipline in 1999*", suggested that the drudgery involved in accounting work will be handled by computers. He expects that the status of the profession will be higher, because the profession responded positively to its demands.³⁾ Another attempt at futurism was, "*The Decline and Fall of the Accounting Profession*", by Thomas W. McRae, who records an address by a professor in the year 2011.⁴⁾ This attempt at futurism is very pessimistic indeed, and analyses the reasons, as seen in the year 2011, for the fall of the accounting profession.

Canadian endeavours to anticipate the future are possibly highlighted by the Summary Report of the Task Force 2000, which was commissioned in April 1969 to examine the present and future roles of the chartered accountant, and to formulate and recommend appropriate plans for the development of the profession. The Report was published in 1970.⁵⁾

In a prologue to the Summary Report, the committee endeavoured to anticipate the future and saw the accounting profession becoming more interdisciplinary and involved with problems of pollution, urbanization, housing, transport and poverty as well as those of social change. Human resources accounting is seen as an important aspect for the future. It further anticipated the importance of current value accounting and the development of more meaningful financial statements based on current values to report on management's

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- 3) Horngren, Charles T., "The Accounting Discipline in 1999", *The Accounting Review*, January 1971, p.11.
- 4) McRae, Thomas W., "The Decline and Fall of the Accounting Profession", *Accountancy*, November 1961, as reprinted in *The Journal of Accountancy*, June 1962, pp.66/68.
- 5) *Canadian Chartered Accountant*, November 1970, "Task Force 2000 - A Summary Report", pp.334/341.

effective use of resources. The prologue also anticipates the accountant in the future not being actively involved in the actual development and operating of systems but relying on management information systems specialists to do this. There can be no doubt that greater demands will be made of the profession in future and an examination of these demands may be fruitful. Briefly, these demands may be: accepting greater responsibility for the detection of fraud, attestation of projected financial statements and forecasts, expressing an opinion on the effectiveness of management, and accepting greater social responsibility.⁶⁾

In an attempt to predict the future Frank S. Capon, a former president of the Canadian Institute of Chartered Accountants, wrote an article, "*Choosing the Future of Accounting*". He states that the profession has a choice of confining its task either to financial accounting and auditing, which he refers to as "the bookkeeping road" or following the uncharted road to total information processing, utilizing mathematical models or simulation of operations, thus providing the necessary information for management. He refers to the latter approach as the total accounting concept but believes that the excellence in the bookkeeping function will still have to be maintained.⁷⁾

In another look into the future the Long Range Planning Committee of the Illinois Certified Public Accountants Society sees the profession undergoing a continued period of experimentation so as to define its area of expertise.⁸⁾ It states that techniques developed to assist in the expression of an opinion on financial forecasts have proved

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- 6) *Canadian Chartered Accountant*, May 1970, "Task Force 2000 - Prologue", pp.320/326.
- 7) Capon, Frank S., "Choosing the Future of Accounting", *Canadian Chartered Accountant*, September 1972, pp.43/46.
- 8) Illinois Society of Certified Public Accountants, "The CPA Profession in Illinois in 1990", A Synopsis of the Report to the Board of Directors of Illinois Society of Certified Public Accountants by the Long Range Planning Committee, Chicago, September 1973.

unsuccessful and that the inclusion of human resources within financial statements have proved more intriguing than practicable.⁹⁾ It also sees the future audit being a more automated discipline requiring the assistance of non-Certified Public Accountant data processing personnel.¹⁰⁾

A more recent analysis of the scope of services to be rendered by the profession has been published by the American Institute of Certified Public Accountants.¹¹⁾ It sees the accounting profession having to accept greater responsibilities because the public will expect a higher level of assurance on the reliability of financial reporting resulting in the search for more effective methods to attain this end.¹²⁾ It sees greater involvement possibly in the areas of interim reports, profit forecasts, adequacy of record keeping and internal control and the economy, efficiency and effectiveness of government programmes. It states:

"This is not intended to suggest that the profession will ultimately decide that it should undertake to provide all of the requested services. But it should not decline to do so without giving full consideration to each request."¹³⁾

No doubt other attempts have been made at prophesying the future, but the conclusions of those referred to above see the profession accepting greater responsibility. An examination of potential extensions of the service of the profession follows, as such extensions will influence the education of the future chartered accountant.

9) *Ibid.*, p.8.

10) *Loc. Cit.*

11) American Institute of Certified Public Accountants, "Final Report of the Committee on Scope and Structure", New York, July 1975.

12) *Ibid.*, pp.13/14.

13) *Ibid.*, p.13.

2.3 Disclosure of Projected Financial Information and the Future Role of the Accountancy Profession in Relation thereto

It is a trite observation to state that the social environment has changed quite dramatically in the past decade or two and that this change can be expected to be maintained and possibly even to be accelerated. An examination of the literature abroad indicates that the disclosure of projected financial information may be of greater importance in the near future. An academic, Charles L. Mitchell, states in this regard:

"Private and institutional investors and their financial advisers are not concerned with corporate financial history as an end in itself, but only as a decreasingly useful piece of information for projecting future corporate profits and dividends and ultimately future share market value. The auditor must satisfy the needs of these people or suffer the fate of the dodo." 14)

The fate of the auditor may be over-dramatised but the whole question of projected financial information is a great challenge to the accountancy profession.

Before examining the pro's and con's of disclosing forecasted financial information, it is possibly necessary to define what is meant by forecasted financial information. It has been suggested that the publication of financial forecasts will imply regularity, that is, publication on an annual basis and if need be, revisions as well as distribution similar to that of annual reports. The financial information refers to earnings and earnings per share, measures of volume, assets and funds and cash flows.¹⁵⁾ The forecasted information will be based on budgets but the forecasts may be slightly more conservative than the budgets for internal use. In determining the requirements of forecasted financial information it is necessary to examine the needs of the users. They are basically interested in the future

14) Mitchell, Charles L., "Disclosure of Budgeted Financial Statements", *Canadian Chartered Accountant*, November 1969, p.326.

15) Cohen, M.S., "Publication of Financial Forecasts" in *Disclosure of Forecasts*, Australian Society of Accountants, Melbourne, 1974, p.1.

prospects of the company, the market prospects of the company and how the business will be financed. M.S. Cohen believes that forecasts for three years should be published showing both the current and the next two years, and the abbreviated balance sheet should show total assets subdivided into current and fixed, total funds, divided into shareholders' funds, fixed term liabilities and other liabilities.¹⁶⁾ He then continues expecting abbreviated cash flow statements to be shown over a period of three years, a statement of the assumptions on which the financial information is based, the sales for the three years indicating a measure of total profit for the three years, profit before tax and before extraordinary items for one year as well as after tax profits before extraordinary items for one year. Other information would be earnings per share after tax and before extraordinary items for one year, and the nature and amount both before and after tax of significant extraordinary items which are anticipated for a period of three years. The disclosure of extraordinary items is anticipated as being possible sale of fixed assets such as plant on the acquisition of new plant in substitution of the old plant. The statement of assumption is again required.¹⁷⁾

The desirability of providing information for three years may be questioned, because of the rampant inflation that has occurred during the last few years. Antagonists of revealing projected financial information will no doubt state that present rates of inflation will make a mockery of the publication of projected financial information.

What justification is there for the inclusion of projected financial information in the annual reports for the companies? The rampant development of large groups has resulted in the shareholders being totally divorced

16) *Ibid.*, p.8.

17) *Loc. Cit.*

from management. The limitations of financial statements based on historical cost have been shown in no uncertain terms. It is argued that companies prepare budgets for internal purposes and all shareholders should be entitled to this information. Shareholders presently rely to a large extent on investment analysts who have much less information than that available to the management of a company. This leads to gossip and speculation which could have misleading results. It is further stated that the efficiency of management can be judged by comparing forecasted results to the actual results. Another justification for the inclusion of projected financial information is that the shareholder requires all relevant information to determine whether the investment is in his best personal interest. The best source to obtain this information must no doubt come from the management of the company and not be based on speculation.

Many disadvantages are cited and these are seen as the competitors gaining important information, the forecasts proving to be erroneous, and serious strikes and other natural disasters causing the forecasts to be inaccurate. It could possibly lead to market manipulation of the shares and to placing undue emphasis on short term expectations. Another disadvantage is that the company may not be run as efficiently as possible because the managers may be pre-occupied with meeting their budgeted figures, and long term benefits will be sacrificed to maximise present earnings. Other arguments against disclosure of budgets are that it may result in smoothing of income because profits may be suppressed so as to ensure that the following year's figures will be attained notwithstanding an anticipated drop in earnings. For forecasts to have any credibility an independent opinion is necessary and at this point in time it is very doubtful whether the auditing profession would be prepared to accept the great responsibility of expressing an opinion on annual forecasts because of the added legal responsibilities that will accompany such an opinion.

In another paper by Ronald Ma and Malcolm C. Miller, certain advantages resulting from a disclosure of forecasts are seen. A correct forecast will be an indication of management effectiveness, and management will improve internal forecasting systems which will result in improved company efficiency as well as increased productivity.¹⁸⁾ They further state that disclosure of forecasts will be likely to improve the operation of the capital markets.

It appears that the publication of profit forecasts is receiving a fair amount of attention in overseas' publications. A recent editorial in *Accountancy*, the monthly journal of The Institute of Chartered Accountants in England and Wales, presents a strong case for the publication of annual forecasts. It admits that the first and second attempts at forecasting may not be as accurate as desired but this will improve. The editorial expresses the belief that the sooner publication of forecasts materialises the better.¹⁹⁾

A review of the situation in America reveals that the Securities and Exchange Commission has now allowed companies which are prepared to reveal forecasts which conform to certain directives of the Securities and Exchange Commission may be published. An American viewpoint with regard to publication of forecasts has been expressed by Ed Weinstein in a paper presented at the 2nd Jerusalem Conference on Accountancy. He refers to an editorial of the influential New York Times which stated that financial statements provided inadequate information about current value of a company's resources, its liquidity or anticipated cash flow, and states:

"As a rule, the reports are too general to meet the needs of users - with individual investors, bankers or public interest groups - who do not have access to inside information. Overall the primary criticism directed at accountants is that they

18) Ma, Ronald and Miller, Malcolm C., "Forecasts and External Reporting", *Disclosure of Forecasts*, Australian Society of Accountants, Melbourne, 1974, p.41.

19) "The Publication of Profit Forecasts", *Accountancy*, March 1975, p.1.

have been at pains to protect the interests of their corporate clients but not those of the outside public." ²⁰⁾

Weinstein is rather perturbed that the benefits of forecasts are possibly being overplayed and that the investors public does not realise their limitations. He fears that the credibility of the profession may risk further damage if profit forecasts go wrong. However he continues:

"The concensus in the United States seems to be that forecasting is a concept whose time has arrived. Publication of forecasts is a part of the mosaic of full disclosures, considered highly desirable in the United States. Three states have joined the SEC in pressing for publicly available forecasts." ²¹⁾

The chairman of one of the "big-eight firms", Mr. Harvey Kapnick has averred that one of the corner stones of the Certified Public Accountant will be destroyed if the auditor reports on forecasted statements. He regards the most essential ingredient of the Certified Public Accountant, to be his independence, which could be impaired because of pressures to achieve the forecasts.²²⁾

A review of forecasting in the United Kingdom, done by D.R. Carmichael refers to pressures exerted and states in this regard:

"... the pressures exerted do not differ significantly from a management's natural desire to achieve acceptable operating results when forecasts are not published." ²³⁾


An objection, that forecasts may be inherently inaccurate, requires further investigation. The experience in the late sixties and early seventies in the United Kingdom was fairly favourable, as approximately 80% of forecasts were within a margin of plus or minus 10%.²⁴⁾ With

20) Weinstein, Edward, "Auditor's Report - Societies Expectations -v- Realities", presenting an American Viewpoint at the 2nd Jerusalem Conference on Accountancy as reproduced in *Critical Problems of External Financial Reporting*, National papers, Institute of Certified Public Accountants in Israel, Tel Aviv, October 1974, CVII p.1. (Emphasis added by Weinstein).

21) *Ibid.*, CVII pp.27/28.

22) Kapnick, Harvey, "CPA's Independence - An Issue in Forecast", *The Journal of Accountancy*, May 1972, p.11.

23) Carmichael, D.R., "Reporting on Forecasts: a U.K. Perspective", *The Journal of Accountancy*, January 1973, p.42.



24) Ma and Miller, *Op.*  UNIVERSITEIT VAN PRETORIA
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regard to forecasts in South Africa, the present guidelines are based on those of the United Kingdom Institute. There have been one or two unfortunate incidences where the forecasts in prospectuses have been grossly overstated.

Although it is acknowledged that the uncertainty regarding forecasted financial information can create many problems, it must be borne in mind that changes in reported financial information to shareholders will come - albeit very slowly. If these changes result in the publication of forecasted financial information, it is necessary that the credibility thereof be enhanced by the opinion of outsiders. In such an event the accountancy profession throughout the world will have a great challenge. There are many problems that will require examination and the challenges will have to be met so that the problems may be resolved.

The scope of the examination will have to be determined. The present practice regarding prospectuses is basically checking the arithmetical calculations and if the underlying assumptions are completely unrealistic, a reservation no doubt will be made. As long as the underlying assumptions are clearly stated, it may be necessary for the auditor to refer positively to the underlying assumptions. The approach to the audit of projected financial information will have to be resolved. An examination of the literature reveals that attempts at designing audit programmes for forecasted information have been made.²⁵⁾ The wording of the independent report will have to be finalised. Another hurdle to be overcome is the spectre of legal liability which will be looming over the independent reporting accountant.

No doubt much empirical research is still needed regarding the publication of projected financial information as well as determining the auditor's role in this. The

25) Attempts at formulating auditing procedures have been made by: Guy, Dan, "Auditing Procedures for Projected Financial Statements : A Suggested Approach", *Canadian Chartered Accountant*, June 1972, pp.20/27. Carmichael, D.R., "Composite Programme Profit and Working Capital Forecasts", *Journal of Accountancy*, January 1973, pp.45/47. This was based on the United Kingdom practice. One of the first attempts was by Yugi Ijiri, "On Standards, Accounting  les and Budget-Auditing  68, pp.662/667.

auditor of the future may ultimately have to express an opinion on profit forecasts and this may necessitate the formation of teams including economists, statisticians, market specialists and financial experts. It has been suggested that a panel, which is taken to be a "statutory panel", be formed with the power to accredit accountants as having the necessary competence to submit forecasts, to grant exemptions where publication may be damaging to a company, to approve forms and contents of forecasts and to advise whether revised forecasts are required.²⁶⁾ The future accountant will have to be very competent and specialisation will result. If the profession is expected to express an opinion on forecasted financial information, its members may be inclined to ask the question:

"If the attest function is presently to be extended, am I a man or superman?"²⁷⁾

2.4 Half-Yearly Financial Statements of Listed Companies and the Auditor's Responsibilities

The importance of timely interim financial information for shareholders and other interested parties is not questioned. This information is required for important decisions by investors, governments and management of companies. It is imperative that if interim financial information is to be of any value, it must be released expeditiously. It has been stated:

"Quarterlies should be timely indicators of progress and problems, and we think it far more important to release highlights promptly than to issue complete statements tardily."²⁸⁾

The whole matter of the auditor's involvement and interim financial statements has caused great controversy in the United States of America. During December 1974, the

26) Cohen, M.S., *Op. Cit.*, p.21.

27) Wolman, B.S., *Auditors Report - Society's Expectations -vs- Realities*, Presenting a South African Viewpoint, a paper presented at the 2nd Jerusalem Conference on Accountancy, The Institute of Certified Public Accountants in Israel, Tel Aviv, October 1971, CV, p.21.

28) Price Waterhouse, New York, *Interim Financial Statements*, A position paper, 1975, p.4.

Securities and Exchange Commission published amendments requiring listed companies to indicate, in annual financial statements filed with the Commission, certain quarterly data for the two most recent years.²⁹⁾ This information would include net sales, gross profit, income before extraordinary items and the effective accounting changes, and the net income. It appears that the Commission did not believe it necessary for the auditor to audit the interim financial statements but on the other hand it was not prepared to allow the footnote data to be indicated as unaudited. During April 1975 the Securities Exchange Commission amended the requirements for quarterly information allowing the word unaudited to be used.³⁰⁾

The Securities Exchange Commission's proposal has caused great controversy and the *Wall Street Journal* of 11 April 1975 indicates:

*"Unlike the rule for annual reports, there isn't currently any requirement that quarterly or other interim reports be subject to independent audit. However, quarterly reports of earnings and sales frequently have greater impact on the market of a company's stock than the annual report does."*³¹⁾

One of the "big-eight" firms, Coopers and Lybrand, proposed a limited review of interim statements by public accountants. This led to the Securities and Exchange Commission being petitioned by another "big-eight" firm, Arthur Andersen & Co., to prohibit the limited review. The Securities Exchange Commission rejected the petition.

Many problems are foreseen. If opinions are to be expressed on half-yearly financial statements, the necessary auditing procedures will delay the publication of these results and will no doubt lead to an escalation in the auditing fees. Financial information to be of use must be speedily prepared and be reliable. The continuous

29) Sprague, William D., "Interim Financial Reporting and Continuous Auditing", *The CPA Journal*, July 1975, p.16.

30) *Loc. Cit.*

31) Stabler, Charles N., "Limited Review 'of quarterly reports' of Firms as Proposed by Auditors Group", *The Wall Street Journal*, 11 April 1975.

spectre of legal liability also hangs over the heads of the accounting profession in the United States of America, and fears have been expressed that the image and credibility of the profession could take a further hammering if the profession was to become involved by expressing an opinion on interim financial statements. The American Institute of Certified Public Accountants issued a proposal whereby the limited review would include checking a company's accounting controls, identifying unusual changes in the balance sheet and submitting a profit and loss statement. The interim reports would be checked quarterly and the findings which would be for the benefit of the management and the board of directors would not be made public.

The responsibility for the preparation of interim financial statements must surely rest squarely on the shoulders of management. The reputation of directors of listed companies will be at stake if they make completely irresponsible half-yearly profit announcements. The Coopers and Lybrand proposal, namely that of a limited review, resulted in a great response, in the form of letters to the Financial Executive, a monthly journal. In one letter, Gary L. Depolo, vice-president and controller, Trans America Corporation states:

"... I continue to believe that financial statements are the primary responsibility of management and that the vast majority of managers act responsibly and do not need to be policed every three months." 32)

This view is very strongly supported in another letter which states:

"However, I remain dedicated to the principle that the integrity and completeness of interim reports are, and should remain, management's responsibility. This responsibility includes establishing ongoing internal control procedures to ensure that quarterly data are consistent with annual reports, that accounting principles and procedures are properly reviewed and that interim modifications are appropriate. ... For the vast

32) Depolo, Gary L., in a letter entitled "Financial Statements are Management's Responsibility", in *Financial Executive*, January 1975, p.41.

majority of companies I believe it is presumptuous for Coopers and Lybrand to suggest, either directly or by innuendo, that auditor participation in preparation of interim reports is needed and should be required." ³³⁾

The Coopers and Lybrand proposal did cause considerable controversy and reaction from many financial controllers of companies. One response states:

"I think it is significant that some of our most notorious cases of management dishonesty have been reported to the public in annual reports to which an unqualified opinion of the auditors was attached." ³⁴⁾

The author then continues that if major frauds could have been perpetrated with unqualified opinions and stringent procedures for test and verification, what are the prospects of frauds not being detected under the quarterly review techniques which were proposed?

A Canadian viewpoint states that often a company's interim financial statements have boosted shareholders' expectations of the year-end results and these expectations were not realised when the audited financial statements were published. This results in considerable hardship, and the question is posed whether the likelihood of such an occurrence would not be reduced if interim financial statements were audited. ³⁵⁾ The attestation of interim financial statements could possibly lead to new auditing techniques and a continuous audit may thus evolve. ³⁶⁾ The view that interim financial reporting may result in continuous auditing is also supported by American experts. ³⁷⁾ Siblin states with regard to interim reporting:

"Once again, if the public demands it the profession will have to fill the need and work out the mechanics." ³⁸⁾

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- 33) Thompson, Robert C., Controller - Shell Oil Company, "Honesty and Competence not restricted to Auditors", *Financial Executive*, January 1975, p.42.
- 34) Hanmer, A.P., Vice-President - Controller, The Dowl Chemical Company, in a letter entitled, "The Review and Comfort Letter", *Financial Executive*, January 1975, p.46.
- 35) Siblin, Herbert Elliot, "Audit Report - Society's Expectations -vs- Realities", National Author, Canada, a paper presented at the 2nd Jerusalem Conference on Accountancy, October 1974, published in a book containing the national papers, entitled, *Critical Problems of External Financial Reporting*, The Institute of Certified Public Accountants in Israel, Tel Aviv, October 1974, CI, p.16.
- 36) *Loc. Cit.*
- 37) Sprague, William D., *Op. Cit.*, p.17.
- 38) Siblin, *Op. Cit.*, CI p: 16

In another American viewpoint, Ed Weinstein, finds the problem of legal responsibility disturbing and states:

"The New York Stock Exchange White Paper says that such reviews and consultations should not impose liability on the independent auditor. As these reviews become more formal and tend toward continuous auditing it is hard to see how such exposure can be avoided." ³⁹⁾

Weinstein then continues to point a finger at security analysts who he avers are responsible for abuse emanating from interim reports and he continues:

"CPAs are being pushed into accepting greater responsibility for accuracy because of the failure of users to act prudently. And, rather than criticizing these users for their lack of perspective, and hence, responsibility to others in the market, the SEC moves inexorably ahead towards a 'solution' which may cause even more undesirable consequences." ⁴⁰⁾

In South Africa, presently, Section 303 of the Companies Act, of 1973, as amended, provides that public companies should issue an unaudited half-yearly report, and if estimates are used, this must be stated. The half-yearly report must be approved by the board of directors and signed by two directors. The interim report is to be issued not later than three months after the expiration of the first six months and is to be sent to every shareholder and debenture holder. The proviso of "fairly present" also applies to the half-yearly financial statements.

The accountancy profession in South Africa will no doubt have many reservations about expressing an opinion on half-yearly financial statements. The present manpower shortage will no doubt be aggravated by such requirements.

39) Weinstein, Edward, *Op. Cit.*, CVII, p.22.

40) *Ibid.*, CVII, p.26.

In the short to medium term it cannot be seen that the profession will become involved in the expression of opinions of half-yearly financial statements in South Africa. In the long term, possibly fifteen years, the possibility cannot be excluded that the profession may become far more involved in interim financial statements. It would be too bold to state that it will be the case, but this is a distinct possibility. As South Africa often follows the leading accountancy nations in the world, this could also lead to an expression of opinion on half-yearly financial statements.

Greater involvement by the accountancy profession in various aspects, such as the expression of an opinion on half-yearly financial statements, may result in the approach to auditing being changed, and the application of a high level of expertise in various disciplines is a very distinct possibility. A multi-disciplined approach consisting of experts from the fields of management science, budgetary control, computers, industrial engineers and economists is a distinct possibility. In the long term it may be that the complete structure of the accountancy profession may change. Accountants are generally conservative and changes come slowly but eventually they do materialise.

2.5 . Detection of Fraud

The views of accountancy bodies throughout the world vis-a-vis detection of fraud are well known. The profession in South Africa does not guarantee that frauds will be discovered and the viewpoint of the South African profession is best illustrated by quoting from Statement A1 of The National Council of Chartered Accountants (S.A.) on Auditing Principles and Standards:

"An audit is not a substitution for management control and no guarantee is given or to be implied that an audit will necessarily disclose fraudulent misappropriations. Responsibility for the financial control and accounts of an undertaking rests upon those who are entrusted by the proprietors with its direction and management ... Management is responsible for safeguarding the assets of the undertaking and is not

entitled to rely upon the auditor for protection against defects in its administration and control." 41)

This viewpoint is endorsed by the Public Accountants' and Auditors' Board. It has always been emphasised that management accepts responsibility for financial statements of companies and that the auditor is only expressing an opinion on the fairness of such financial statements. The expectations of society vis-a-vis auditors' responsibilities and detection of fraud differ quite substantially from the auditing profession's interpretation of its responsibilities. Society places reliance on attested financial statements and A.M.C. Morrison sees the position as follows:

"Not surprisingly this view is scarcely shared by laity or the press, who consider that if an audit is not meant to uncover major frauds then it must be of very little use. ... It is absurd to say that they are all right subject of course to the possibility that undetected fraud may have made them all wrong." 42)

Notwithstanding the accountancy profession's endeavours to advise the investors public what its duties are, if a major fraud is eventually discovered the immediate reaction of investors is: "Where were the auditors?" It may be stated without fear of contradiction that the investors' public does expect the auditor to discover frauds. An empirical survey undertaken in Australia by G.W. Beck confirms this opinion. Respondents were expected to indicate whether they strongly agree, agree, disagree, strongly disagree, or are unsure about certain statements. The statement with reference to fraud read:

"You expect the auditor to give you assurance that there have been no frauds perpetrated by company officials."

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- 41) Statement A1 of The National Council of Chartered Accountants (S.A.), "Auditing Principles and Standards", April 1964, par. 4., p.3.
- 42) Morrison A.M.C., *The Role of the Reporting Accounting Accountant Today*, a paper presented to a summer school of The Institute of Chartered Accountants of Scotland, 1970, p.18.

Of the 711 responses, 661 indicated that they strongly agree and agree with the statement. The reliance placed on the auditor was further illustrated by responses to two further statements. The statement,

"You would buy shares in a public company only if it was audited." elicited 94% agreement. The responses to a statement,

"You expect the work of the auditor to give you assurance that: the company's accounting statements are reliable."

elicited 98% agreement.⁴³⁾ There can be no doubt that the investors' public places substantial reliance on the accountancy profession. The chief accountant of the Securities and Exchange Commission in the United States of America, John C. Burton, is reported as saying:

*"The historical position of the auditor, which seems to be that fraud is not what the CPA is responsible for finding, has to be reconsidered ..."*⁴⁴⁾

The profession faces a great challenge in detecting management frauds. The credibility of the profession in the United States of America has diminished quite substantially because of law suits against public accountancy firms. The problem of detecting management frauds is a controversial one and Edward Weinstein states in this regard:

"There is a real difference of opinion within the profession regarding the feasibility of detecting management fraud. It has by no means been established that we have the ability to detect all management fraud. But it is our responsibility to determine when financial statements do not present fairly the financial position of a company. Therefore, if a fraud is so pervasive as to destroy the very fabric of financial statements we are auditing, we must strive to detect this condition. We may not always be successful, but we cannot afford to fall back on the thinking that collusive actions always defeat internal controls and circumvent audit techniques."

43) Beck, G.W., *Public Accountants in Australia - Their Social Role*", Australian Accounting Research Foundation, Melbourne, 1974, pp.143, 145 and 146.

44) Dixon, Arthur J., "CPAs Face Their Responsibilities", *The CPA*, June 1975, p.23.

This negativism would stultify all efforts to discover such problems and thus be abandonment of duty. Therefore, I believe that the performance gap between public (here, the SEC) expectations and reality can be narrowed.

At the same time we and our public must recognize that every instance of management fraud cannot be detected. ... We must be diligent and thorough but cannot be scapegoats ..." 45)

It must be admitted that the profession may have to accept greater responsibility for the detection of fraud and this could possibly be achieved by having non-executive directors of listed companies serve on audit committees. The latter consists mainly of non-executive directors of companies and it is the committee's responsibility to liaise with external auditors on audit matters and financial reports. The committee consists mainly of non-executive directors and is thus independent of management. The audit committee forms an important link between the auditors and management.

The rationale for a corporate audit committee is that it enhances the independence of the external auditor. Advocates of the audit committee believe that it will enhance public confidence in financial reporting of companies and at the same time it assists the auditors in performing their functions more effectively.⁴⁶⁾

A Canadian viewpoint on audit committees states:

"The audit committee gives the auditor an open forum at which he can present his point of view about certain matters which come to his attention during the course of his work. Considering the fact that a majority of the audit committee members are directors who are not part of management, the directors as a result of these meetings, can maintain greater control over management's activities. This liaison must increase the auditor's effectiveness." 47)

45) Weinstein, Edward, *Op. Cit.*, CVII. p.15.

46) Lam, Wai P., "The Development and Significance of Corporate Audit Committees", *CA Magazine*, April 1975, pp.36/37.

47) Sibling, Herbert Elliot, *Op. Cit.*, CI. p.19.

There can be no doubt that the standard of internal control should improve through the introduction of audit committees. It is sufficient to state that improved internal control no doubt facilitates the auditor's task. It may be argued that listed companies in South Africa are not that big to warrant the creation of audit committees, but experience has shown that even in large groups the internal control leaves much to be desired. On the directorates of these companies there are prominent members of the business world. It is believed that if these directors were better informed about the deficiencies in the internal control of these companies, they would attempt to improve the standard of internal control.

The position concerning the absence of fraud is seen by G.W. Beck as follows:

"If auditors are to attempt to meet the expectations of shareholders they cannot avoid expanding tests and embarking upon often wide searches for additional supporting evidence for particular transactions even when these appear to be validly recorded. In view of the time and cost involved and the fact that, even then, there would be merely greater assurance and not a guarantee of the fidelity of officials, this expansion appears to be unsupportable. One cannot realistically expect more than a competent audit that should, in the absence of clever manipulations, bring to light any major defalcations." 48)

The detection of collusive frauds and resultant legal liability in the event of collusive fraud not being detected, has had a major impact in the United States of America. Much research has been done recently in this regard and Douglas R. Carmichael, director of the Auditing Standards Division of the American Institute of Certified Public Accountants, believes that an audit cannot be a guarantee against fraud, but it should provide reasonable grounds for the honest belief that material frauds have not caused the financial statements to be mis-stated.⁴⁹⁾ In his address Carmichael referred to

48) Beck, G.W., *Op. Cit.*, p.133.

49) Carmichael, Douglas R., address given at the Annual Meeting of New Mexico Society of Certified Public Accountants, as reported in *The Journal of Accountancy*, June 1975, p.16.

"red flags" which should assist the auditor in detection of possible frauds, and which are warning signals which will require further investigation. These warning signals are seen where: companies with insufficient working capital continue their operations; extremely rapid expansion has taken place through new business or product lines; urgent needs for favourable earnings records to support the listed price of a company's shares; dependency on a single or relatively few products; participation in an industry experiencing a large number of business failures.⁵⁰⁾ In another article, Carmichael suggests a concept of levels of assurance which will range from a denial of assurance when a Certified Public Accountant is acting as an accountant in performing a write-up engagement, to a maximum form of assurance when he will be performing the traditional audit.⁵¹⁾ Carmichael suggests that the users of financial information be informed about the different types of assurance. The profession has been reluctant to accept the concept of levels of assurance because of the fear that the investors' public will not understand the full implications of the different levels of assurance.⁵²⁾ If such a proposal was accepted, this would result in Auditing Standards Committees drafting the necessary standards of field work, giving the format of report that would adequately convey the nature of the examination involved, as well as indicating the limited degree of responsibility assumed.

In a recent article the question is asked whether the words of Lopis L.J., in the Kingston Cotton Mill Company: "He is a watchdog but not a bloodhound?" still apply. The question is raised whether the twentieth century auditor should not possibly be a cross-breed between a watchdog and a bloodhound?⁵³⁾

50) *Loc. Cit.*

51) Carmichael, D.R., "The Assurance Function - Auditing at the Crossroads", *The Journal of Accountancy*, September 1974, p.69.

52) *Loc. Cit.*

53) McQuoid-Mason, D.J., and Cookson, C.R., "20th Century Auditors - Watchdogs, Bloodhounds or Crossbreeds?", *The South African Chartered Accountant*, December 1975, p.422.

Another way in which the profession in South Africa could possibly improve the performance of practitioners is to establish a quality review programme similar to the one instituted by the American Institute of Certified Public Accountants. A comprehensive discussion of the quality review programme is contained elsewhere.

Edward Weinstein states in this regard:

"The SEC contends that some of these frauds could have been detected through better application of existing techniques. It has proposed extensive peer review and the profession seems willing, although reluctant, to adopt such a program. ... The objective of peer review is to achieve uniform quality throughout a firm or an entire profession. ... There is little doubt that the public expects uniformity of professional practice up to a minimum norm. ... There is similarly little doubt that peer review is an excellent device for accomplishing the goal of standardizing practice. ... The SEC contends that in order to be effective, peer review must be conducted from outside a firm. It is not sufficient to have the review performed from outside the office unit. ... At some point in the future, as more experience is gained with outside review programs, both the profession and the SEC must assess the value of the 'independence' in the peer review concept against the duplicated cost caused by this approach." 54)

In conclusion it may be stated that detection of material frauds must not become an obsession as it will cloud the more meaningful services that the accountancy profession has to offer. It is believed that material frauds will be detected during the normal auditing procedures if these are performed with the requisite degree of care and skill. The auditing profession throughout the world has a major public relations programme, that is to keep the investors' public better informed of the profession's responsibilities.

54) Weinstein, Edward, *Op. Cit.*, CVII. pp.16/18.

2.6 Management Audits

The term, management audit or management auditing, is a very controversial one indeed. Operational auditing is another phrase for this procedure. One definition of the management audit is:

(It)"involves a comprehensive and constructive examination of an entity or one of its components, such as a division or department - its plans and policies, its financial controls, its methods of operation, its use of physical and human resources - in order to evaluate the effectiveness of management in carrying out assigned responsibilities and accomplishing specified objectives; a review of the system of internal control inclusive of administrative controls as well as accounting controls is clearly envisioned in a management audit." 55)

Another definition of the management audit reads:

" ... is an audit which results in a statement of opinion by a CPA with regard to the performance of the management function." 56)

Another definition, rather vague though, is:

"Management auditing is characterized more by a state of mind than by distinctive methods." 57)

In another analysis of the meaning of the term, management audit, William L. Campfield endeavours to conceptualise a management audit in preference to a strict definition

"An informed and constructive analysis, evaluation, and series of recommendations, regarding the broad spectrum of plans, processes, people and problems of an economic entity." 58)

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- 55) Nurnberg, Hugo, "The Independent Auditor's Attest Function : Its Prospects for Extension", *New York Certified Public Accountant*, October 1971, pp.727/732 and 783/788, as reprinted in *Readings in Auditing*, edited by Brasseaux and Edwards, published by South Western Publishing, Cincinnati, 1973, pp.37/38.
- 56) Churchill, Neil C., and Cyert, Richard M., "An Experiment in Management Auditing", *The Journal of Accountancy*, February 1966, p.39.
- 57) Camus, Bradford, *Operational Auditing Handbook*", The Institute of Internal Auditors, New York, 1964, p.51., as quoted by Norgaard, Corine G., "The Professional Accountants View of Operational Auditing", *The Journal of Accountancy*, December 1969, p.45.
- 58) Campfield, William L., "Trends in Auditing Management Plans and Operations", *The Journal of Accountancy*, July 1967, p.42.

Campfield sees the management audit as a three-fold approach, with the first being a review of the prescribed organisational structure, which entails an investigation of personal inter-relationships, policies, procedures, information systems and flows and decision centres in order to determine what management has established as optimum arrangements for following an entity. The second aspect is evaluating the live entity. This entails a determination of whether the management is accomplishing the established objectives and a measurement of how the results achieved compare with pre-determined goals and standards of performance. The third aspect is searching for profit inhibitors such as poor organisational structuring and responsibility assignment, breakdown in work flow, ineffective communications and the disclosure of results that fall significantly below the established standards.⁵⁹⁾

Another definition of the management audit reads:

"Examination and evaluation of management information systems. Review of business policies and plans, and of investment decisions (in the light of evidence of consideration and evaluation of alternatives, inter-firm comparisons and particular industrial or commercial background etc.). Examination of reasons for not achieving the planned results. (If good plans are achieved, sound management can be assumed; the converse is not necessarily true)." ⁶⁰⁾

Before investigating other controversies surrounding the management audit, an analysis of the demand for a management audit should be made. It may be stated without fear of contradiction that: *"Losses due to mismanagement of companies is most probably substantially higher than losses due to fraud ..."* ⁶¹⁾

In his analysis of the social role of public accountants in Australia, G.W. Beck tested society's expectations

59) *Loc. Cit.*

60) Vieler, D.E.G., "The Accounting Profession Today and Tomorrow", a paper presented at the fourth summer school of The Cape Society of Chartered Accountants, Hermanus, Cape, May 1973, reproduced in booklet form by Price Waterhouse Johannesburg, p.6.

61) Wolman, B.S., "Aud:  ety's Expectations -vs- Realities", *Op. Cit.*

in this regard and respondents were requested to indicate their degree of agreement or disagreement with the statement:

"You expect the work of the auditor to give you assurance that: management is efficient."

Of the 711 responses, 48% strongly agreed with the statement, and 23% agreed, thus indicating that 71% are in agreement with this particular statement.⁶²⁾ In analysing these expectations, G.W. Beck does not envisage the management audit as being a part of the model role of the future accountant. He states:

*"The functional implications of auditors attempting to provide information on the efficiency of management generally are, from the auditor's point of view, quite disconcerting. This action would call for a degree of expertise that must be beyond what may reasonably be expected of auditors. The efficiency of technical management outside the accounting department can usually be assessed only by those at least as well versed in the specialist function. ... It seems auditors should endeavour to make shareholders aware of the impossibility of complying with this expectation."*⁶³⁾

The rationale for the management audit can further be justified by the fact that management is an important resource and it is in the interests of shareholders to know how effectively their company is being managed. The importance of management condition must be stressed as financial conditions are not the only indicators of the ability to survive and grow.⁶⁴⁾ Implication that management condition is as important as financial condition implies that the financial audit and the financial statements do not convey the complete picture of an organisation. Management effectiveness of any company is an important indicator for investment analysts but the investment

62) Beck G.W., *Op. Cit.*, p.150.

63) *Ibid.*, p.136.

64) Smith, Charles H., Lanier, Roy A., and Taylor, Martin E., "The Need for and Scope of the Audit of Management : A survey of Attitudes", *The Accounting Review*, April 1972, p.271.

analyst as an outsider will find difficulty in assessing the effectiveness of management. Shareholders also have a vested interest in a management audit because they want to know how effectively their capital is being utilised. During the last decade or so the social environment has changed quite substantially and public interest must not be overlooked. The public interest has a hard look at corporate management in its management of scarce resources and other aspects such as environmental controls.

A vexed question is determining who should do the management audit. Should it be done by internal auditors or should it possibly be done by the external auditors? If ultimately a report is submitted to the shareholders then this will preclude the internal auditors from expressing an opinion. Many writers endeavour to present a strong case for the Chartered Accountant or Certified Public Accountant rendering this service. The justification for this is that the audit of management can be regarded as a logical extension of the current audit function. There are differences of opinion as to whether this is in effect the case as it may be affirmed that the management audit could be regarded as a special type of management service engagement. Corine T. Norgaard concurs with the view that it is an extension of the traditional audit and she states:

"This is true because of the entity-encompassing nature of the operational audit and because the professional accountant's concept of its purpose is the discovery of problems rather than their solution. On the other hand, the management services engagement is generally considered to be oriented toward the solution of a specific problem or problems which are known to exist when the engagement is undertaken." ⁶⁵⁾

Justification for the accountancy profession doing the management audit is that in the financial audit a firm's internal control is reviewed and the audit of management

65) Norgaard, Corine T., "The Professional Accountant's View of Operational Auditing", *The Journal of Accountancy*, December 1969, p.46.

would to a large extent involve a similar evaluation. It is further stated that the accountancy profession enjoys professional recognition and the standards of competence and independence are an invaluable asset in this regard.⁶⁶⁾ Another justification is that as the chartered or certified public accountant conducts a financial audit other professionals need not be called in. Utilisation of the external auditors to do this assignment will result in a reduction of the costs involved. Another view is expressed by Morse, who states:

"The term 'performance auditing' suggests that the full range of management's responsibilities are within the auditors purview. This brings further extension of his evaluations to the accomplishments of the organization or the effectiveness of its operations in achieving established or prescribed goals or objectives. This is a logical extension of the auditor's work." ⁶⁷⁾

An attempt at futurism has been made by the eminent author, Howard F. Stettler, in his article, *CPAs / Auditing / 2000 ±* who does not envisage the auditor expressing an opinion on management. He considers management capability to be qualitative rather than quantitative factors, whereas quantitative results could be reviewed objectively.⁶⁸⁾ Opponents of the management audit affirm that "Monday morning quarter-backing" or hindsight is very difficult as an outside auditor, who does not have the same technical know-how of that particular industry, cannot place himself in the same position as members of management when they made critical decisions. The auditor will not be under the same pressure and stresses as the manager was at that particular point in time.

Another survey, indicates that the management audit is

66) Smith. et. al. *Op. Cit.*, p271.

67) Morse, Ellsworth H., "Performance and Operational Auditing", *The Journal of Accountancy*, June 1971, pp.45/46.

68) Stettler, Howard F., "CPAs / Auditing / 2000 ±", *The Journal of Accountancy*, May 1968, p.58.

not a potential extension of the attest function.⁶⁹⁾
 The responses of public accountants indicate that nearly 83% are against the extension of the attest function to include an opinion on management effectiveness, whereas 100% of the controllers of corporations indicated that they were against such an extension - thus a unanimous rejection of this potential extension. The reason for the rejection by the public accountants was that there were no meaningful standards of measurement by which to attest management efficiency.⁷⁰⁾

Many problems will be encountered, no doubt, before the management audit will eventually be accepted by the accountancy profession throughout the world. The significant problems are: that there are no generally accepted auditing standards and procedures for management audits; that there are no objective criteria for the evaluation of managerial abilities and performance; that the competence of auditors to conduct and report on such audits may be suspect; that the question of auditors' independence and legal liability are vexed problems to be overcome in relation to the management audit. The framework for the future management audit is seen by John C. Burton as entailing four areas: firstly criteria for the management audit must be defined; secondly standards of managerial performance must be developed; thirdly a method of reporting must be established to make the results of the report meaningful, and finally not only must the necessary management auditing procedures be developed, but also standards of documentation to support the report must be given.⁷¹⁾ Burton states that the audit must deal with the objective and the measurable and he sees objective as a "*detached, impersonal and unprejudiced*".⁷²⁾ He does not see objectivity as countability and the ability to recount, and states:

"Two ... auditors might emerge from an audit with slightly different

69) Imke, Frank J., "The Future of the Attest Function", *The Journal of Accountancy*, April 1967, p.55. The survey was not designed to make statistical inferences but to determine whether there is a consensus for the extension of the attest function.

70) *Loc. Cit.*

71) Burton, John C., "Management Auditing", *The Journal of Accountancy*, May 1968, p.41.

72) *Ibid.*, p.42.

results but the variation should not exceed that attributable to normal sampling errors if due professional care is used." 73)

The development of performance standards is seen by Burton to be evaluated in terms of procedures and results. With regard to procedures he divides managerial control into five groups: organisational control, planning and information systems, asset management, marketing systems and production systems. Each of these sections is sub-divided into additional groups. He refers to the development of financial standards for the evaluation of performance and cites three measures of relative success. They are:

1. *Ratio of operating return on sales earned by the company compared to the return earned by the industry.*
2. *Ratio of operating return on long-term capital earned by the company compared to the return earned by the industry.*
3. *Comparative variability in return compared to average industry variability."* 74)

The development of a management audit report is no doubt problematical because of the legal implications. Authors see it as being a comprehensive one indicating exactly what has been done. Burton sees the report divided into three sections: a scope section where the nature of the examination will be described; a section in which the auditor evaluates the past performance of the company; and finally a section in which the auditor evaluates current management procedures of the corporation. Burton sees this audit report possibly being as long as two or three pages.⁷⁵⁾ The lead for the management audit is there if the expectations of society are taken into account. There are many important issues to be clarified such as the scope of the management audit as well as the professional standards which are applicable. Antagonists who affirm that the chartered accountant

73) *Loc. Cit.*

74) *Ibid.*, p.43.

75) *Loc. Cit.*

does not have the competence to do this, may be given the counter argument that major changes in the accountancy profession did not occur overnight and that this competence can be achieved in the future by adjusting the educational and training requirements. It is also agreed that the management audit will have to be performed by a group of specialists. Antagonists of the management audit may be correct in asserting that a fair amount of subjectivity may be involved, but there are many objective criteria by which management performance can be evaluated.

The views of the profession in South Africa are divided, but generally they do not favour an extension of the attest function. Analysis of the empirical research appears elsewhere. An investigation into the approaches of other countries may shed some light on the prospects for the management audit. Herbert Siblin states that it is unlikely that the management audit will be accepted by the profession in Canada because of great practical difficulties and does not foresee its introduction in the future.⁷⁶⁾ Although the management audit in Sweden has been in practice for many years, it is still a controversial topic and Bo Fridman, a national author at the Tenth International Congress states:

"When auditors themselves have an unclear concept of the scope and purpose of the examination of the management it is not remarkable that misunderstandings should arise among the users of audit reports." ⁷⁷⁾

2.7 Management Advisory Services

Management advisory services departments of many firms have grown quite substantially during the last decade or two. A controversial aspect of management advisory services is the question of auditor's independence. It is stated by certain authorities that involvement with

76) Siblin, Herbert Elliot, *Op. Cit.*, CI p.17.

77) Fridman, Bo, "The Audit Report", a paper presented at the Tenth International Congress of Accountants in Sydney, October 1972, as reproduced in the book of "National Papers", p.352.

management advisory services impinges on the independence of the auditor. Mautz and Sharaf state:

"There tends to come a time in any arrangement, for management services when the mutuality of interest of the consultant and the client becomes so significant that the consultant ceases to be independent in the sense that we feel he should be for auditing purposes. Management requests advice because it expects to use it; the consultant gives it to be used; the consultant knows that as a consultant he will be judged by the ultimate usefulness of his advice in bringing success to management's efforts. He has had a hand in shaping managerial decisions and will be judged by management on the same basis that the management itself will be judged. How then can he claim to be completely independent?" 78)

This a very convincing argument, based solely on principle, will be difficult to counter.

It is acknowledged that one's independence may be affected by the fact that one's own management advisory services department has designed a system on behalf of a client but it is imperative that management be given various alternatives so that it may take the final decision. It must be stressed that management must take the decision.

A justification for the management advisory services may be stated as follows:

"Timeous advice given by accountants which irons out the weaknesses in a client's organisation will be appreciated more than an analysis of why things went wrong in the organisation at a later stage." 79)

In a discussion on management advisory services and accounting, Benzion Barlev and Arie Goldman see the question

78) Mautz and Sharaf, *The Philosophy of Auditing*, American Accounting Association, Monograph No.6., p.222.

79) Wolman, B.S., *Op. Cit.*, CV., p.17.

of independence in the following manner:

"It should be realized, however that the question whether the two can be combined is no longer open. MAS has already become an integral part of auditors' activities. Attention should, therefore, focus on devising methods by which auditors may provide MAS without adversely affecting their auditing responsibilities."

They continue:

"Auditing services are, however, the raison d'etre of the accounting profession and only CPAs are allowed to provide such services. In contrast, MAS can be provided from many sources. If these latter functions will become the major aspect of auditors' activity, the accounting profession may lose its professional uniqueness and challenges may arise to the legitimacy of its MAS engagement from others who offer advisory services." 80)

In conclusion it may be stated that the services of the management advisory services department of large accountancy firms will be demanded as long as they meet the requirements of their clients. If the demand is there, the challenge should be met.

2.8 Conclusion

The challenges facing the accountancy profession in future will be great and expectations of society will change rapidly as is shown by the changes during the past decade. The accountancy profession throughout the world has suffered because of the many cases against it, particularly in the United States of America, have made its credibility suspect. Even in South Africa there are certain cases pending which may further damage the image of the profession.

A mammoth task facing the profession is the improvement of the credibility of information reflected in financial statements. Double-digit inflation has made a mockery of financial information based on historical costs data. A proliferation of literature during the last year indicates that the matter is receiving attention. The objectives

80) Barlev, Benzion and Goldman, Arieh, "Management Advisory Services and Accounting", *Abacus*, June 1974, p.82.



of the preparers of financial statements will have to be defined clearly, and indications are that the future chartered accountant will require a broader education to meet the challenges. If galloping inflation continues, the future chartered accountant will require greater depth of knowledge in various subjects such as economics and mathematical techniques.

The growth of multi-national groups with their accompanying accounting problems will also test the future accountant's competence. Other demands may also be made on the auditing profession. It appears that in the taxation field, the accountancy profession will be expected to make a greater contribution if the Department for Inland Revenue moves to self-assessment. If the indications that this move to self-assessment may gain momentum in the near future are true, the already overburdened accountancy profession will have to face another challenge with an increased work load.

A fairly detailed exposition of society's expectation of the auditing profession has been made above. The purpose has been to state the premise, that because of anticipated growing expectations of the accountancy and auditing profession in future, the future chartered accountant will require a broader education. It is acknowledged that many of the anticipated changes may at this particular point in time be hypothetical, but at the same time it must be acknowledged that the accountancy profession has generally been conservative in the past and has accepted changes very slowly. These changes do eventuate and it is important to bear in mind that the future chartered accountant must have a broad education and not just simply be an "accounting technician" or "glorified bookkeeper". He will have to be a thinking accountant capable of evaluating and solving complex problems.