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REMARKS OF ELMER B. STAATS
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AT THE
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AUDITING AS WE ENTER THE 21ST CENTURY--
WHAT NEW CHALLENGES WILL HAVE TO BE MET

I am pleased to be here today at this gathering of the American Accounting Association. Yours is a truly prestigious organization with singular accomplishments in accounting and auditing research of which your 12,000 members can be proud. Your distinguished President, Dr. Maurice Moonitz, is a renowned scholar and author, and his contributions to the accounting profession are well known.

It seems to me entirely appropriate that we are meeting here at the "Crossroads of the Pacific" for these discussions because in my view, the auditing profession is at something of a crossroad itself. We have seen auditing come a long way from its strictly financial orientation to a much broader range of activities. Now, we see that new changes may be in store, and new challenges await us in the near future. It is on these changes and challenges that I would like to focus my remarks today.

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THE NEW AUDIT ENVIRONMENT

[What will the audit environment be like as we enter the next century? To begin with auditors will be reviewing financial statements with assets and liabilities stated in current values.] This change will be a radical departure from today's environment, but one which seems to be inevitable.

[Accountants already recognize a need to record the effects of inflation on corporate profits and losses.] Several approaches are under discussion, but if the past is any indicator, the immediate solution will probably be no more than to take the effects of inflation on corporate earnings and bury that information somewhere in a footnote to the financial statements, or to include in annual reports supplementary information on the effects of changing prices. Of course the Securities and Exchange Commission already requires companies it regulates to make certain disclosures on the effects of inflation on their operations. They supply the information in footnotes to their financial statements--information such as what it would cost at today's prices to replace existing plant, equipment, and inventory. However, the overall effects of inflation are not readily discernable in the statements themselves.

[The problem is manifested when companies pile up record profits on paper, at the same time pressing the Congress for tax relief.) This point is made graphically by information on sales and dividends of several major corporations that the Financial Accounting Standards Board has compiled for

a 5-year period. The information shows that companies such as United States Steel, International Telephone and Telegraph, and Sears, Roebuck & Company--all of which had sales increases of several billion dollars over that period--were actually only maintaining the same or lower volume when these figures were restated in constant dollars. The same was generally true for shareholder dividends paid by these companies.

When investors see their dividends expressed in constant dollars, they get a more accurate indication of the actual return on their investment. This type of information also is helpful to people investing in their own business, or when joining with others in a partnership or corporation, as well as to regulatory authorities and other governmental agencies concerned with the preservation of the equity interest in an enterprise.

With so much at stake for such a wide variety of people, continued inflation will eventually force companies to report assets, liabilities, and earnings at current values.

[Another change I foresee is increased independence for both internal and external auditors. This increased independence will grow largely out of the function and structure of audit committees.] These committees, [which] will soon become standard in almost every large firm, [will be responsible for disclosing relevant information to the public. A company's internal auditors will report directly to the audit committee.]

[This committee will hire the public accounting firm that audits the company's books.] Management will have no voice in the selection of the outside auditors. Under this system the [audit committees will be composed of outside directors, not of company management personnel] wearing two hats. By having only outside directors on the committees, the auditors' independence will be substantially increased.

As you know, in June of last year, the New York Stock Exchange adopted a requirement that each domestic company with common stock listed on the exchange must have an audit committee. I believe that in the next 20 years we will see audit committees formed in virtually all companies, and the result will be improved auditing.

[Another area where I foresee improvement occurring involves the disclosure of the unfunded or underfunded liability of State and local government pension funds.]

[Presently, the way a State or local Government handles its retirement plan is not subject to Federal control.] Such plans are not subject to the standards set by the Internal Revenue Service for qualification of plans or to the Pension Reform Act of 1974. As State and local government has grown in the past 20 years, so has the size of unfunded or underfunded liabilities. For example, the fire and police pension system of the City of Los Angeles is in the midst of a 70-year amortization of the unfunded vested liability of the system--a liability in excess of a billion dollars. The pension plans

in the State of New York are known to be underfunded. Proportionately greater unfunded liabilities are carried by many other public pension plans.

There are a number of reasons for the growth of unfunded pension liabilities. Some plans had to assume liability for the past service of employees who have been with a governmental unit for many years. Other plans have had increases in the pension benefit formula or have added improved benefits, sometimes in response to a strike or threatened strike of government workers. Still others have incorporated actuarial assumptions that did not correctly reflect past experience.

Whatever the cause, [it is apparent that when a pension plan for a governmental unit is not fully funded, the security of the benefits earned by its participants becomes dependent on the future taxing capability of that unit.] Furthermore, as we in the General Accounting Office have pointed out in our reports on Federal pension plans, [when currently accruing retirement costs are not fully recognized the true costs of Government programs are understated.] Most of us would agree that current operating costs of Government should be borne by the current beneficiaries, and that present taxpayers should pay the cost of current Government services, including the costs to assure that future retirement benefit expectations will be met. But this assurance requires that the extent of unfunded or underfunded liability is known and reported,

not currently the case for far too many governmental pension plans.

I am optimistic that this situation will be corrected in future years, and that we will see the extent of unfunded or underfunded pension plan liabilities being determined by qualified actuaries and disclosed to the public, along with the reports of independent auditors who will examine each pension fund annually. A major step in this direction was taken last year when legislation was enacted subjecting Federal pension plans to financial reporting requirements similar to those for private plans under the Pension Reform Act. Further legislation has been proposed to subject State and local pension plans to such reporting requirements.

But I have been telling you of things that have been widely debated, and most of you would probably agree with these forecasts. I would next like to turn to some more esoteric--and perhaps more controversial--things that I believe auditors will be involved in by the year 2000.

AUDITING MODELS OF POTENTIAL PROGRAMS

[One of the more interesting changes that we may see in the future is using auditors--particularly Government auditors--to audit models of programs before they are undertaken and to render opinions on the reliability of factors used in estimating the cost of these programs before they are

started.) This has already proven to be a useful concept in the Federal Government and should be equally useful in corporate auditing. As you know, some of the largest of our Federal programs started at modest levels and grew to gigantic proportions, often to the surprise of those who approved them. In the future, this kind of unwelcome surprise may be eliminated if program models are audited and assessments of cost factors made known before development is undertaken.

I would like to take a moment to elaborate on this thought. As you know, a model is a simplified representation of the interrelationships among elements of some portion or aspect of reality. This definition can be applied to many different things, from a toy car to a full-scale prototype of a supersonic aircraft; and from the game of Monopoly, which represents the real estate business in Atlantic City, to a set of mathematical equations that represents the behavior of the national economy.

When it is impractical to manipulate a system itself, a model generally can be used to capture the system's key features. A model is thus an abstraction of reality which preserves only those features which are most relevant to its purpose.

Models, of course, must be used judiciously. However, because the Congress is becoming increasingly interested in

the use of models and because the number of more complex audits is growing, the General Accounting Office, in the future, will be doing more reviews using models.

Recently, GAO developed models to evaluate how the Navy's spare engine support system for the F-14 engine would function using GAO's stock level proposal. This was done in conjunction with a report we issued entitled "Alternatives Available for Reducing Requirements for Spare Aircraft Engines."

We also developed a model during our review of the Defense Department's plans for a new Naval hospital in San Diego. That model proved to be a better method than ones previously used to measure the need for acute care beds. The Defense Department now uses our model for determining the size of its new and replacement hospitals, and we are working with the Veterans Administration to adapt our model to its hospital construction projects.

Another model was developed at GAO to evaluate the effect that the antirecession assistance of Title II of the Public Works Employment Act of 1976 has on stimulating the economy during a downturn.

In addition to developing our own models, we have often used models developed by others in making our reviews. For example, we used models to determine the potential impact on trade of increased taxation of U.S. citizens

employed overseas, and to predict the probability that individuals will or will not file income tax returns.

From this, I think you can see that the role of models is growing in Government, and in all probability will continue to do so. Eventually, the auditors in Government as well as in private industry will have to become familiar with modeling concepts--including how to develop them and how to evaluate those developed by others.

MORE OPERATIONAL AUDITING IN THE CORPORATE WORLD

[Another change I foresee involves the type of audits that will be conducted in the future. While there will continue to be an abundance of financial audits, we will also see an increasing number of reviews directed toward determining the economy, efficiency, and effectiveness of operations within corporations.] We in the General Accounting Office have been conducting reviews of the economy and efficiency of Federal agency operations for some time now, and currently approximately one-half of our reviews are designed to evaluate program effectiveness, that is, to determine whether certain Federal programs are being carried out in accordance with the legislative intent of the Congress, and carried out in the most cost-effective manner.

This is an area where the American Accounting Association can play an important role through research and education.

[Research is needed to adapt the techniques of the General Accounting Office's economy and efficiency and program

effectiveness reviews to the private sector; education is needed to develop a new breed of auditors to carry out these audits.) With a little modification, these types of reviews could be carried out within companies by internal auditors as well as public accounting firms. I suggest that you will be seeing them more and more frequently in audits of future years.

One of the more intriguing possibilities along this line involves including information in financial statements to describe the economy, efficiency, and even the effectiveness of Government agencies and private corporations in carrying out their missions. For example, if a unit within a Government agency has a mission to plant a certain number of trees in a fiscal year, and does it for x number of dollars, it would be possible for the agency's financial statements to note that the trees were planted at that cost, or less; or that fewer trees were planted, or that it cost more than was anticipated. This type of supporting data in Government financial statements could prove quite valuable to management and to readers of the statements. We will be seeing this type of data in some form or another in Government--and perhaps even in corporate--financial statements by the next century.

SOCIAL ACCOUNTING WILL RECEIVE MORE EXTENSIVE USE

I hesitate to use the phrase "social-accounting" because it means different things to different people; however, I

believe that by the year 2000 auditors will be doing some things that could be categorized under this term. For instance, I believe that by then [we will find better ways to measure the costs and benefits of many things that today are imprecise and subject to much controversy. Such as

--whether the energy spent in certain pursuits is worth its cost to society;

--whether the quality of life of the community and workers is enhanced by certain pursuits; and

--whether the benefits of certain industries, including the products or services they produce and the profits and salaries generated, are worth the costs to society in terms of pollution and consumption of scarce resources.]

I believe that we are in a society which will become increasingly concerned about these issues and which will insist that, in the future, auditors and program analysts be called upon to help evaluate the costs and benefits involved in issues of social accounting.

CHALLENGES FOR THE AUDITING PROFESSION

The changes I have predicted are intended to set the stage for the remainder of this discussion--our consideration of the critical challenges facing the auditing profession, and how we must face those challenges.

I will be talking separately about three challenges but practically speaking, together the three form an even

larger problem--and that is, getting the audit profession to live up to the expectations of the public. The public generally perceives financial auditing as something that guarantees honesty in financial statements. In fact, if you look up "auditing" in the current edition of the World Book Encyclopedia, you will see that it says that a financial audit, and here I will quote, "tells the officials of an organization whether their financial decisions have brought the desired results. Such independent investigations also ensure honesty in the organization's public financial statements."

How did the public get the notion that an audit ensures honesty? Perhaps because in earlier years--around the beginning of the 20th century--auditing's primary purpose was to detect fraud and irregularities in financial transactions. One auditing manual, published in 1898, stated that the three objectives of an audit were to detect fraud, technical errors, and errors of principles. The main concern was whether cash on hand, accounts receivable, inventory, and other assets could be accounted for.

(As you know, over the years the emphasis on fraud detection has waned to the point that auditing textbooks now generally refer to fraud detection as a responsibility not assumed by the auditor.)

How is this dichotomy of beliefs of the public and the auditing profession going to be resolved in the next two decades? In my opinion, (the problem of fraud detection is

inextricably related to a second problem of internal controls, and both must be considered in the context of a third problem in our futuristic society, namely, there will be virtually no paper transactions to audit. } I will try to separate these three issues in the next few moments because I see them as the major challenges facing the auditing profession, and as problems that must be resolved in our universities.

AUDITING THE PAPERLESS TRANSACTION

{ As more and more financial transactions are handled by automatic data processing, the first problem the auditor of the future is going to face is the virtual disappearance of paper transactions. } Already such innovations as electronic funds transfer are becoming commonplace in the banking industry. What will auditors do when this paperless state becomes complete? { Without records of paper transactions that occurred weeks or months ago, auditors will require new audit procedures to decide whether financial transactions were handled properly. }

It is inevitable that these new procedures must allow auditors to perform their tests of transactions as they occur, since there will be no paper record to examine. And if that is the case, { better audit planning will be needed so that the many tasks now performed sequentially can be performed more or less simultaneously. }

{ Auditors will also have to rely far more on the effective functioning of systems than they do now. } So better techniques

than we now have for testing such systems must be developed.

PROBLEMS ASSOCIATED WITH
REVIEWING INTERNAL CONTROLS

(With paper transactions virtually eliminated, and the auditors checking more into the adequacy of these systems, internal controls will become increasingly important.) As you know, several organizations, including the AICPA's Commission on Auditors' Responsibilities--the Cohen Commission--have strongly suggested that public interest requires corporate reporting on the adequacy of internal control. More recently, the Securities and Exchange Commission proposed that after December 15, 1979, management of all corporations under its jurisdiction be required to report on the effectiveness of internal accounting controls, describing any material weaknesses communicated by independent accountants which have not been corrected. After December 15, 1980, the management statement would be required to be examined and reported on by an independent public accountant.

It now seems certain that reporting on internal controls will soon become a reality for nearly all companies and for all levels of government as well. I believe that both internal and external auditors will be involved in this process.

Internal auditors will be involved because internal accounting control is an area where the corporate internal auditor's depth and breadth of knowledge is superior to everyone else's--inside or outside the company. They will play a role in monitoring the company's internal control system,

conducting comprehensive examinations of that system, evaluating it, and making recommendations for modifications.

Evaluating internal controls is going to become a major issue in the future. But a difficult problem that must first be faced is that [financial controls are changing--radically changing--as the direct result of the use of computers.] Many functions performed today both in industry and in Government would be virtually impossible without the computer. However, computers have greatly complicated the internal control problem. }

One aspect of this problem is the computer's ability to cover distances of thousands of miles in minutes in completing a transaction. For instance, the purchase order may originate in New York, the receiving document in California, and the invoice in Washington, D.C.--[the transaction being completed before any employee can examine any physical data relating to it.] The purchase order is generated by the computer when stocks get too low; the goods are received and the computer is notified; and the computer matches the documents and authorizes a disbursement. Finally, the check is signed by signature insert in the computer and the transaction is completed with virtually no "human" examination.

[What we will soon need is a complete new set of accounting controls based on computer operations.] Moreover, [as our reliance on computers increases, so will the need for these new control systems to be in good working order--] for we will

have nothing to rely upon to protect against fraud, abuse, and error except the adequacy of the control system.

Perhaps our greatest obstacle in achieving this goal of adequate control is time. While we have had roughly 500 years since the Italians invented double entry bookkeeping to develop internal controls for manual systems--and even these controls are not perfect--we have had only about 20 years since computers became used extensively to adapt the internal control approach to computers. In the next 20 years, much will have to be done to bring the internal controls in such systems to a level where we can feel confident about them and we will need systems of surveillance to ensure that the controls we generate are used.

Of course, all controls will have to be weighed against the cost involved. } A "risk analysis" of sorts will have to be made that assesses the potential damage that the lack of a control might permit and compares it against the potential cost of preventing that damage. Management must make this decision, just as it must see that all the responsible officials cooperate in setting up the necessary controls, and that the personnel resources necessary to keep them effective are devoted to the task.

I note in this context that our Office recently published, as a supplement to our Auditing Standards, a booklet of additional standards entitled "Auditing Computer Based Systems." We have been concerned for some time that the audit coverage

accorded computer based systems does not measure up to the quality needed to assure that proper results are obtained. Our study of the area led to the development of these supplemental audit standards to provide guidance for auditors involved in such work. These standards are effective January 1, 1980, and earlier compliance is encouraged. They will be incorporated in the next revision of the basic document "Standards for Audit of Governmental Organizations, Programs, Activities & Functions."

THE AUDITOR'S ROLE IN
FRAUD PREVENTION AND DETECTION

The question of internal controls has a large impact upon the problem of fraud prevention and detection. As I stated earlier, the public usually looks to the financial audit as a means of ensuring honesty in financial statements, but the auditing profession, in recent years, has disclaimed most of its responsibility for fraud detection.

This is an area where problems have been building in recent years. Some believe the problems first surfaced after Watergate, when investigations made it clear that many corporations had made questionable or illegal payments--including domestic political contributions and payments to foreign officials to obtain or maintain business. These problems, combined with such fraudulent activities as the Equity Funding scandal have made the Securities and Exchange Commission, some members of the Congress, and the public critical of the auditing profession for failing to prevent and detect such irregularities.

Here again is an area with equal applicability to the Federal Government. Concern about fraud, abuse and error was a major consideration in the creation by the Congress last October of Offices of Inspector General in the major Departments and agencies. That legislation requires the Inspectors General to comply with standards established by the Comptroller General. We will be revising our standards shortly to incorporate specific provisions relating to the prevention and detection of fraud, abuse, and error.

Responding to the same concern, I established a Fraud Prevention Task Force within the General Accounting Office. In September of last year, our Office issued a report entitled "Federal Agencies Can and Should Do More to Combat Fraud in Government Programs." We pointed out that no one knows the magnitude of fraud and abuse against the Government. Hidden within legitimate undertakings, it usually goes unreported and undetected. The following month, I established the Special Task Force for the Prevention of Fraud. The major responsibilities of this group are to evaluate the adequacy of management control systems in Federal agencies necessary for the prevention of fraud and to assess the adequacy of followup and corrective actions taken on reports of Federal agency auditors and investigators. (Where management control systems are properly developed and are functioning properly, the possibility of fraud, theft, or error is greatly diminished.)

Conversely, where the systems do not exist or are not being used properly, the opportunities to defraud the Government and the possibility of error increase dramatically.

The GAO Task Force will concentrate on agency controls over cash and receivables, inventories and supplies, and anything else of value that might be stolen or misappropriated.

[Since computer systems offer many possibilities for fraud, we will identify weaknesses in computer controls over payrolls, payments to vendors, and cash disbursements for other purposes.] We will also be looking at needed controls to ensure that the Government gets what it pays for, and that the work stipulated in contracts is actually performed.

Our Task Force will build upon the work of internal auditors in Federal agencies. We will analyze their reports, paying particular attention to indications of fraud or error in internal audit reports. (Federal internal auditors often stop one step short of actually identifying fraud and simply report what they find as error or mismanagement.) For example, in the highly publicized General Services Administration scandals, a number of the fraudulent schemes were noted by auditors in their reports but not labeled as fraud. For instance, auditors would report that 50 gallons of paint were provided to a contractor to paint an 8 foot by 20 foot wall, or that spark plugs in Government cars were being changed every month. Of course what was happening was not mismanagement, it was fraud and theft. The Task Force will be looking at Federal

internal audit reports, attempting to find such possibilities of fraud.

(We are making fraud prevention--not detection--our top priority. Our work will concentrate on strengthening control weaknesses in agency systems that permit fraud to occur.) As we uncover potential fraud and abuse in our work, we will be looking for patterns that can be explored in other agencies.

We do not, of course, intend to ignore fraud that has already occurred. For example, we established in January a tollfree telephone line which allows any citizen to report instances of suspected fraud to the Task Force for investigation and possible prosecution.

To date, the "hotline" has produced more than ten thousand calls and thousands of leads of alleged mismanagement or wrongdoing. These include theft, private use of Government property, improper financial transactions, bribes, kickbacks, and extortion.

Perhaps there is a parallel between what we are doing in the Government and what could be done in the private sector to prevent and detect fraud and abuse. Certainly an excellent opportunity exists for public accounting firms to work with the internal auditors of the firms they are auditing just as we are doing with Federal internal auditors.

It is evident that the audit committees I spoke of earlier are going to be taking on a wider range of responsibilities

in the future. One of the audit committees' goals will be to seek compliance with the Foreign Corrupt Practices Act of 1977, which not only makes it generally unlawful to bribe foreign officials but also contains far-reaching provisions requiring the maintenance of books, records, and an adequate system of internal accounting control by public companies.

Corporate internal auditors, if permitted to report directly to the audit committees, can assist the audit committees by establishing and monitoring internal control systems and providing an independent source of information. Who should know better the weaknesses of internal control systems than internal auditors? In the future public accounting firms will undoubtedly be coordinating more closely with corporate internal auditors to detect and prevent fraud.

But new auditing procedures which provide greater assurance against fraud must be developed if the auditor of the 21st century is to be effective in this area.

AUDITORS WILL BE BETTER EDUCATED

Finally, a word about the education of auditors. To meet these new challenges (the auditors of the future will have to have extensive and continuing education.) Auditors will have to be much more proficient, for example, in data processing since virtually all transactions will be handled electronically. Training in fraud prevention and detection

will become standard in the auditing curriculum. I feel certain that the American Accounting Association will be in the forefront in improving the education of the future auditor.

SUMMARY

I have covered a wide range of topics the past few minutes. Perhaps I should take a moment to summarize the points I have covered before concluding.

In essence, by the year 2000, the auditing profession will undergo radical changes. Some accounting principles will certainly change--for instance, we will probably see assets and liabilities stated at current values.

Internal and external auditors will be reporting to audit committees composed of directors outside the organization, thus giving audit a new independence that will improve audit reporting. Auditors will begin auditing models of programs and offering their opinions on the validity of the factors used to estimate the costs associated with these programs. They will be involved in social accounting issues and in auditing companies that operate quite differently from those we see today.

There will be an increase in the number of audits that involve determining the economy and efficiency of operations and the effectiveness with which governmental and corporate missions are being carried out. Much of this

information will be included in Government financial statements to better evaluate the organization's operations. Governmental financial statements at the State and local level will provide improved financial reporting, particularly in the disclosure of unfunded or underfunded pension fund liabilities.

Paper transactions will be virtually eliminated, and auditors will have to review transactions as they occur. Moreover, they will concentrate more on tests of systems than on testing individual transactions.

Internal controls will be better developed and more thoroughly understood by management. Auditors will conduct reviews to see that the controls are functioning properly, and their reports on deviations from these controls will be regarded seriously.

New auditing procedures will be developed which provide greater assurance against fraud. Auditors who fail to follow these procedures will be held accountable for serious instances of fraud.

Finally, auditors will receive continuing education. They will be more proficient in data processing and fraud prevention and detection by virtue of this increased education.

THE AMERICAN ACCOUNTING ASSOCIATION
WILL PLAY AN IMPORTANT ROLE

In concluding, I would like to offer a challenge to the members of the American Accounting Association. I know that those who formed the Association more than 60 years ago

included a number of dissidents who wanted to change the course being followed by accountants in this country. Moreover, your by-laws state that an important purpose of the Association shall be "to initiate, encourage, and sponsor research in accounting and to publish or aid in the publication of the results of research." Accordingly, I want to challenge all of you to commit the strong research leadership of the Association to solving the problems I have addressed today. We in the General Accounting Office pledge our full support to this effort and will do all we can to see that the solutions are found.