THE

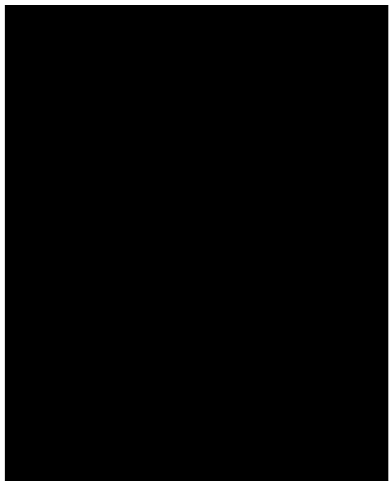
AUDITOR'S

REPORT

Volume 23, No. 2, Winter 2000

AUDITING SECTION/AMERICAN ACCOUNTING ASSOCIATION

REPORT OF THE PRESIDENT



Karen Pincus

As the new century is just beginning, we mark the halfway point in the Auditing Section's fiscal year. So far, it's been a banner year.

What's Gone By

If you didn't make it to Newport Beach in January, you missed a great meeting. About 250 people participated. The 2000 Midyear Meeting kicked off with a well-attended CPE session on electronic commerce implications for assurance education and research presented by Glen Gray (California State University), Marilyn Greenstein (Lehigh University), and Tom McKee (East Tennessee State University). The day before the meeting also included the Section's inaugural Doctoral Consortium, chaired by Michael Bamber, University of Georgia. The consortium exposed about three dozen students to ideas from leading auditing researchers and journal editors and provided many networking opportunities. This first consortium was so successful, the Section will continue the consortium next year.

The meeting's plenary speaker, David Landsittel, set the tone with an insightful discussion of "Auditing: Some Current Challenges." His remarks may be found in an article starting on page 12 and in electronic version on the Section's web site. The core program included presentations of 28 research papers, as well as instructional cases, five panel sessions, and a working paper forum. Many of the papers are now available (for a limited time) on the Section's web site. The meeting was also the occasion for presentation of four Section awards, which you can read about elsewhere in this newsletter.

The success of the 2000 Midyear Meeting was due to the contributions of the many reviewers, participants, and especially the efforts of the Planning Committee, chaired by Joanna Ho, UC-Irvine. Thank you all for an excellent job! The 2000 group has set a high benchmark for the 2001 Planning Committee, already hard at work under the direction of Linda McDaniel (University of North Carolina). The 2001 Midyear Meeting, to be held in Houston, will mark the Section's 25th anniversary.

Another event that occurred during the first half of the fiscal year was the presentation of the views of Section members to the Panel on Audit Effectiveness during the Panel's hearings in October. Thanks to all who took the time to email their thoughts on a variety of issues. My remarks to the Panel on behalf of the Section are summarized in an article beginning on page 23.

And finally, in January, the Section's new web site was launched, as a combined result of the efforts of the AAA and Section webmaster Lyn Adair (Illinois State University). If you haven't checked it out yet, do so soon. You'll find it much easier to navigate and chock full of useful information.

What's on the Horizon

If you did miss the Newport Beach Midyear Meeting (or even if you were there), you'll find two more great meeting opportunities coming up later this year. In July, the Auditing Section is co-sponsoring the Year 2000 International Symposium on Auditing Research (ISAR). This sixth

(Continued on page 2)

SUMMER ISSUE DEADLINE

The deadline for material to be included in the Summer 2000 issue of *The Auditor's Report* is May 1, 2000. The preferred, but not mandatory, format is Word files attached to email messages. Please send all material to the Associate Editor at the address below by that date to ensure timely publication of the issue:

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The address of the Auditing Section's Home Page on the World Wide Web is:
http://raw.rutgers.edu/raw/aaa/audit/

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annual ISAR will by hosted in the Netherlands by the Maastricht Accounting and Auditing Research and Education Center of Universiteit Maastricht. Selected conference papers will later be published in a supplemental issue of *Auditing: A Journal of Practice & Theory.*

For August, Bob Ramsay (University of Kentucky) and his committee are planning a full slate of activities for the Auditing Section sessions at the AAA Annual Meeting in Philadelphia.

At the Annual Meeting, we will welcome three new Executive Committee members elected at our January Business Meeting: Mike Bamber, University of Georgia, Vice President–Academic; Abe Akresh, U.S. GAO, Vice President–Practice; and Audrey Gramling, Wake Forest University, Secretary. Don't forget to reserve your Monday lunch for the Section's annual speaker event!

[Gary: Tim is checking with Burks Oakley, if we get word in time, I'd like to add a few sentences about him.]

Due to a small glitch, the Fall 1999 newsletter included the proposed revised wording of Section bylaws, but omitted the brief article explaining the proposed changes. Even though the changes were only cleanup amendments, it didn't seem appropriate to vote on them at our Midyear Meeting without better notice. So, we will postpone that vote until our 2001 Business Meeting. At our 2000 Business Meeting, the group discussed some possible substantive changes that could be made at the same time. In particular, there was a discussion of expanding the source of our nominating committee appointments to include all committee chairs as possible candidates (now it includes only regional coordinators). If you have any comments or other suggestions for amendments, please let me know by April 15 so a committee can get to work on proposing the wording and making sure we have adequate notice for a vote. You can email me at: kpincus@walton.uark.edu.

Other Items of Note

- The Section's dues for 2000–2001 will be $20, per a vote at our general business meeting in January. Dues have not increased since 1982, but rising costs (particularly for printing, postage, and distribution of our journal) make this increase prudent. Thanks to Treasurer Mark Beasley (North Carolina State University) for keeping us fiscally sound!
- The Section is continuing discussions with the Management Accounting Section about the possibility of some joint sessions at our Midyear Meetings beginning in 2002. A conference call between the groups is due to take place this spring.
- Beginning this summer, *Auditing: A Journal of Practice & Theory* will be available as part of the AAA's electronic publication options. We will start off with two years of issues on line and gradually add the archive. The electronic version will offer easy links and searching across all issues—and it will take up less space on your bookshelf! The Section appreciates both editor Arnie Wright (Boston College) and our Publications Committee for their help in making this happen.

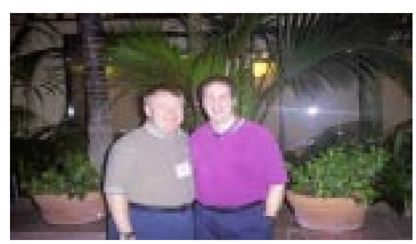
Whew!! That seems like a lot for one fiscal year, doesn't it? As always, the Auditing Section is an active and productive bunch. Thanks to all who keep us operating at this pace!

Karen Pincus
University of Arkansas

SIXTH ANNUAL MIDYEAR AUDITING SECTION MEETING

Joanna Ho, University of California, Irvine; Ken Trotman, University of New South Wales; and Ira Solomon, University of Illinois

The Auditing Section held its Midyear Meeting January 13–15, in Newport Beach, California. The meeting featured the continuing tradition of an interesting and well-attended CPE session. In addition, there was a valuable array of panels and presentations as well as an outstanding plenary speech by David Landsittel (the text of that speech is included in this issue of the newsletter). This year's conference also included the inaugural doctoral consortium. Special thanks go to KPMG for its continuing sponsorship of the Midyear Meeting, and to the Program Committee: Joanna Ho, Chair (University of California, Irvine), Mike Bamber (University of Georgia), Stan Biggs (University of Connecticut), Jeff Cohen (Boston College), Dana Hermanson (Kennesaw State University), Linda McDaniel (University of North Carolina), and Ted Mock (University of Southern California).



Larry Scott of PricewaterhouseCoopers and Joe Carcello, University of Tennessee

CALL FOR PAPERS

SEVENTH ANNUAL MIDYEAR
AUDITING SECTION CONFERENCE

Call for Submissions

The Seventh Annual Midyear Auditing Section Conference and the special commemoration of the Section's 25th Anniversary will be held in **Houston, Texas** on **January 11–13, 2001**. CPE sessions will be held on the afternoon of January 11. The remainder of the conference will consist of keynote, plenary, and concurrent sessions dealing with a wide variety of contemporary topics related to audit, attestation and assurance practices, education, and research. You are encouraged to contribute to the program through submissions of auditing/attestation/assurance research and education papers, and special session proposals.

The conference will be held at the ***JW Marriott Houston.*** The hotel is located in the highly desirable Galleria / Uptown district of the city known for its dining and shopping excellence. Therefore, after a full day of sessions and meetings, there are literally hundreds of options to suit one's entertainment and dining preferences. In addition, the hotel is only seven miles from attractions such as Six Flags / Astroworld, the Astrodome, and the museum district.

Submission Guidelines

Research papers should follow the style guidelines of *Auditing: A Journal of Practice & Theory*. Other submissions should take an appropriate form to permit review of their originality, quality, and usefulness. Submissions are not eligible for consideration if they (1) have been published or accepted for publication, (2) were presented at the 2000 AAA Annual Meeting, or (3) were presented at more than one AAA Regional Meeting or other academic conference. Papers presented at the Research Forum of the AAA Annual Meeting are eligible for consideration. It should be noted that papers accepted for presentation at the 2001 Midyear Auditing Section Conference can also be submitted for presentation at the AAA Annual Meeting scheduled for August 2001.

Only abstracts will be published in the proceedings' booklet. By December 1, 2000, authors of accepted submissions are expected to provide the designated session discussant with a final printed copy. Instructions for placing accepted papers on the Section's web site will be included in acceptance letters.

Submission Deadline

Four copies of submissions must be received by **September 1, 2000**, to be considered for the program. Early submission is highly encouraged. Any questions should be addressed to:

Linda S. McDaniel
Kenan-Flagler Business School
CB # 3490 McColl Building
University of North Carolina, Chapel Hill
Chapel Hill NC 27599-3490
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Fax: (919) 962-4727
Email: mcdaniel@unc.edu

Ideas for Bylaws Changes?

If you have any suggestions for bylaws changes, now is the time to let the Executive Committee know because the issue is now under study. The Fall 1999 *Auditor's Report* had a copy of a proposed bylaws revision. If you have any comments or suggestions for additional changes, please email Karen Pincus at kpincus@walton.uark.edu by April 15. Thanks!

ASB Update as of December 31, 1999

Ray Whittington, DePaul University
Academic Member of the Auditing Standards Board

The ASB has issued two new *Statements on Auditing Standards* dealing with the quality of financial reporting and audit committee effectiveness. In this update I review these standards and identify some related research issues. As always, please contact me if you have any questions, comments, or suggestions.

Audit Adjustments

SAS No. 89, "Audit Adjustments," addresses a concern raised by the SEC about the quality of financial reporting. It establishes audit requirements intended to encourage management to record financial statement adjustments discovered by the auditors. To accomplish this objective the SAS:

- Adds an item to the list of matters generally addressed in the understanding with the client (the engagement letter). The item states that management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements brought to its attention by the auditor are not material, both individually and in the aggregate.
- Requires the auditor to obtain, in the management representation letter, management's acknowledgment that it has considered the financial statement misstatements brought to its attention by the auditor and has concluded that any uncorrected misstatements are not material, both individually and in the aggregate. A summary of uncorrected misstatements (required to be accumulated by SAS No. 47) should be included or attached to the representation letter.
- Requires the auditor to inform the audit committee about uncorrected misstatements brought to management's attention by the auditor that were determined by management to be immaterial, both individually and in the aggregate. The presentation to the audit committee should be similar to the summary provided to management.

Deliberation of this standard became somewhat complicated by the SEC's issuance of SAB No. 99 on materiality. Based on the analysis of issues included in the SAB, there was a concern that communication of the adjustments would elevate them to an illegal act should management decide not to make them. However, based on discussions with SEC staff, it was concluded that mere communication by the auditor would not change the nature of management's decision not to make the adjustments.

Research opportunities related to this new standard would include those focusing on:

- Whether the standard achieves its intended objective of getting management to book more "immaterial" audit adjustments.
- Whether auditors look at the materiality of adjustments in a different light given the issuance of this standard and SAB No. 99.
- The effect of the required communication on audit committees and boards of directors.
- Differences among auditors in the way in which they view various types of audit adjustments.

Audit Committee Communications

Arising out of Recommendations 8 and 10 of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, SAS No. 90 amends SAS No. 61 and SAS No. 71.

The amendment to SAS No. 61 requires the auditor of an SEC client to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting. The standard states that "the discussion should be 'open and frank' and generally include such matters as the consistency of the accounting policies and their application, and the clarity and completeness of the financial statements. The discussion should also include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements."

In addition, the standard refers the auditor to Statement of Financial Accounting Concepts No. 2 "Qualitative Characteristics of Accounting Information" to assist in making judgments about quality, but acknowledges that objective criteria do not exist.

The amendment to SAS No. 71 builds on the SEC's new regulation requiring timely reviews of quarterly financial information (Form10-Q). It requires auditors to communicate the matters in AU Section 380, *Communication with Audit Committees* (previously applicable only to annual financial statements), prior to the filing of the Form 10-Q. This requirement would include the discussion of the quality of accounting principles described above, recognizing that the extent of the information about "quality" derived from a review would generally be significantly less than for an audit.

Related to this issue the ASB is interested in research addressing the following issues:

- What level of expertise on the part of audit committee members is necessary to comprehend a discussion of quality?
- Are there alternative frameworks to FASB Concepts Statement No. 2 to couch the discussions of quality?
- What is the influence of work paper documentation on the willingness of parties to be "open and frank"?
- What effect will these new requirements have on the behavior of audit committees and boards of directors?

CALL FOR NOMINATIONS

Distinguished Service Award in Auditing

The Committee responsible for the Distinguished Service in Auditing Award is seeking nominations from the Section's membership for the award to be given at the Midyear Meeting in January 2001. This award is given periodically and recognizes outstanding and sustained service to the academic auditing profession. The illustrious careers of past recipients of the award, including Bob Roussey, Dave Landsittel, Jerry Sullivan, Don Leslie, Ken Stringer, Robert Mautz, Robert Elliott, W. W. Cooper, Jim Loebbecke, John Willingham, Jay Smith, William Kinney, Fred Neumann, Bob Sack, and the members of the first Practice Advisory Council (Tom Powell, Chair) represent the type of contribution to the profession that exemplifies this recognition. Nominations should be sent by July 1, 2000 to:

Abe Akresh
U.S. General Accounting Office
Accounting and Information Management Division
441 G Street, NW, Room 5S15, Washington, D.C.
[Email is preferred—akresha.aimd@gao.gov]

Outstanding Auditing Educator Award

The Committee responsible for the Outstanding Auditing Educator Award is seeking nominations from the Section's membership for the award to be given at the Midyear Meeting in January 2001. The award is given in recognition of outstanding contributions to the field of auditing education. Prior recipients of this award include Andy Bailey, Ira Solomon, William Kinney, Jack Krogstad, Glen Berryman, Fred Neumann, Howard Stettler, William Felix, Al Arens, Jim Loebbecke, and Nick Dopuch. Nominations should be sent by July 1, 2000 to:

Professor Karen V. Pincus
Department of Accounting
College of Business
University of Arkansas
Fayetteville, AR 72701
Email: kpincus@comp.uark.edu

2000 Auditing Doctoral Consortium

The inaugural Auditing Doctoral Consortium was held the day before the Auditing Midyear Conference in the conference hotel at Newport Beach, Southern California. The consortium was sponsored by the Auditing Section and KPMG International. Thirty-eight students from North America, Australia, Germany, and Hong Kong attended the consortium. Faculty making presentations included Linda Bamber, Bill Felix, Bill Kinney, Mark Peecher, Dan Simunic, Rick Tubbs, and Arnie Wright. Bernie Milano from KPMG attended much of the consortium. The unifying theme of the presentations was that this is an exciting time for research in auditing and assurance services. Students seemed to share this enthusiasm as they actively participated by asking questions and making comments. Their research interests tended to focus on auditor independence and objectivity, fraud, risk assessments, expertise, and assurance services. The Consortium was judged a success in terms of exposing students to the latest ideas in auditing research, introducing them to our journal editors and some of the leading researchers in our field (an opportunity students took full advantage of), and providing students an opportunity to share ideas and network with their peers. Most students stayed for the Midyear Conference.

Mike Bamber, chair and Rick Tubbs, chair-elect comprised the committee that organized this year's conference. Next year's consortium will be organized by Rick Tubbs, chair and Dan Simunic, chair-elect.

An Update on Auditor Independence

On January 14, 1999, the Securities and Exchange Commission brought charges against PricewaterhouseCoopers for violating SEC auditor independence rules. According to the SEC news release, PricewaterhouseCoopers partners and managers were found to have purchased securities of PwC audit clients in more than 70 instances. On January 7, 2000, the SEC released the results of a subsequent review of independence violations at PwC, in which the SEC alleges that about half of the firm's audit partners owned investments in the firm's audit clients, contrary to appearance-based independence rules. The SEC alleges a total of 8,064 violations at PwC, of which about 80 percent were committed by partners. PwC insists that, while appearance-based rules may have been overlooked in some cases, at no time was independence-in-fact compromised. No evidence is available to suggest that audit quality actually suffered as a result of the alleged violations.

This and other recent events have kept auditor independence issues on the front burner in the profession and in regulatory circles. The purpose of this article is to very briefly summarize some of the current happenings regarding auditor independence. In particular, this article focuses on (1) the SEC's recent position in the independence debate, (2) the discussion over independence in fact vs. appearance, (3) attempts currently being made to address auditor independence issues, and (4) the findings and potential role of academic research in the independence debate.

The SEC's Growing Concern

In a speech delivered to the Economic Club of New York on October 18, 1999, Chairman Levitt emphasized his belief that "quality information is the lifeblood of strong, vibrant markets." But he also emphasized his concern that the quality of information in capital markets is increasingly at risk as motivation increases for companies to satisfy Wall Street earnings expectations.

Since beginning his second five-year term, Chairman Levitt has focused in particular on the role the independent auditor plays in guarding the integrity of the information reported in companies' financial statements. He and others in the SEC have repeatedly stressed their concern that auditors' contribution to the integrity of financial statements will be diminished if the perceived independence of outside auditors is in question. For example, in his speech to the Economic Club of New York, Chairman Levitt questioned whether an audit partner can remain independent in discharging his public duty while also trying to sell consulting services to his or her audit clients. Other representatives of the SEC have recently made even more provocative statements. SEC Commissioner Norman S. Johnson recently gave a speech entitled "The Year of the Accountant." In that speech, Commissioner Johnson suggests that "it hardly seems accidental that financial fraud has rapidly increased at the same time nonaudit services performed by accounting firms have proliferated and become more profitable."

Underlying these concerns is a remarkable trend in practice. Most sources report that in the early 1980s traditional audit firms earned approximately 15 percent of their revenues from management consulting services. In contrast, that percentage has jumped to around 40 percent today, while revenues from audit services have dropped to only about a third of total revenues.

Should Standards Be Based on Independence in Fact or Appearance?

At the heart of the current independence debate is the differing opinion between the SEC and the accounting profession over what constitutes adequate independence. Both sides acknowledge the importance of independence for the accounting profession, but they are divided over how independence should be implemented and measured. Many in the profession argue that independence should be measured by the auditor's actual independence in any given case, and are thus urging a fundamental overhaul of the existing appearance-based approach to standard setting. Representatives of the SEC on the other hand argue that independence must be gauged in terms of appearances that may in turn affect investors' perceptions.

A leading advocate for an emphasis on independence in fact is Robert K. Elliott, President of the American Institute of Certified Public Accountants (AICPA). At a recent symposium sponsored by the *CPA Journal* and the New York State Society of CPAs, Elliott argued for a system of standards oriented toward ensuring independence in fact: "Would the passenger of a plane prefer that the mechanics on the tarmac be neatly and smartly uniformed, or that the engines be properly overhauled?" Elliott further pointed out that auditors have a strong incentive to act independently, arguing that "the Big 5 put a half-trillion-dollar asset at risk every time they sign an audit opinion; this is a far greater incentive to maintaining independence than any rule or regulation."

The accounting profession argues not only that provision of nonaudit services does not endanger independence in fact, but also that the insights gained by auditors about the inner workings of different companies and industries can be beneficial to clients in the form of value-added services. Likewise, many in the profession assert that the insights gained through providing nonaudit services contribute to higher-quality audits. They argue that as long as independence in fact is maintained—and they emphasize the strong incentives already in place to do so—the benefits to providing additional services outweigh the potential costs.

In contrast to the profession's position, the SEC argues that auditors must be held to a standard that goes beyond independence in fact. The SEC maintains that the public's perception of the auditing profession is a critical aspect of independence, and that implementation and enforcement of auditor independence must be based on independence in appearance. Thus, the SEC does not favor efforts to change the current appearance-based orientation of independence standards, which currently comprise over 250 pages of rules and guidance. Richard D. Walker, Director of the Division of Enforcement of the SEC, argues that "it's not enough that audit quality is maintained and that the numbers are right. It's also necessary that public investors—the users of financial reports—perceive that the numbers are right." Chairman Levitt goes so far as to warn that if independence in appearance cannot be maintained under the current system, then "perhaps we should give some thought to whether the accounting profession has become so big and complex that we need an alternative self-regulatory approach."

(Continued on page 7)

Current Efforts in the Profession

In an effort to more effectively address auditor independence issues, the AICPA and the SEC worked together in creating the Independence Standards Board (ISB) in October of 1997. While the ISB is working on independence standards, its current priority is to establish a conceptual framework for auditor independence. At a recent symposium, Arthur Siegel, Executive Director of the ISB, commented on the ISB's vision for the framework. "We hope it will do the same thing for us as FASB's framework has done for it. It will constrain and limit discussion, while at the same time provide a common language for presenting the issues and objectives of proposed standards." A "Discussion Memorandum for Public Comment" is expected to be issued in the 1st quarter of 2000 with an "Exposure Draft for Public Comment" being issued in the 4th quarter of 2000.

In January 1999, the ISB issued its first standard, *Independence Discussions with Audit Committees*. This standard requires auditors to disclose any relationships between the auditor and the company that may affect independence, to confirm that the auditor is independent of the client company, and to specifically discuss the auditor's independence with the audit committee.

The ISB is currently working on several other projects, including the following:

- Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)—Exposure Draft expected 1st quarter of 2000, Final Statement expected 3rd quarter of 2000.
- Certain Independence Implications of Audits of Mutual Funds and Related Entities—currently in the Project Task Force meeting phase, Final Statement expected 4th quarter 1999.
- Employment with Client—currently in Exposure Draft form, Final Statement expected 2nd quarter of 2000.

In addition the efforts of the ISB, the AICPA has taken steps to strengthen the independence practices of its members. For example, it recently announced that auditing firms who do business with publicly traded companies will have the responsibility to establish independence policies, communicate these policies to employees, and appoint a partner to administer and enforce these policies.

The issue of independence and objectivity has also been a recent focus of attention in the internal auditing profession. Internal auditors are often asked to consult with management on such things as process, control, and systems improvement. Independence issues can arise, for example, when internal auditors are called upon to audit those same processes and systems they previously helped to improve. To address these issues, a task force jointly cosponsored by the Auditing Section of the American Accounting Association (AAA) and the Institute of Internal Auditors (IIA) is nearing completion on a monograph that will propose a conceptual framework for "managed objectivity." The framework focuses heavily on independence in fact, and is designed to protect the integrity of internal auditors' role as assurance providers through proactive management of potential threats to objectivity.

The Academic Research Contribution

In the past twenty years, over thirty academic research articles have been published in major accounting journals dealing with the issue of auditor independence. This collection of research can be categorized into two areas, (1) the provision of Management Advisory Services and (2) other factors, such as client pressure and compensation schemes, that may affect independence. Some studies in each of these two areas have addressed independence in fact, while others have addressed users' perceptions of independence.

Researchers have used a variety of research methodologies to examine auditor independence. Experimental methods appear to be the most commonly used approach, though studies have also been conducted using archival and laboratory markets approaches. A variety of participants have been used in these studies, including loan officers, financial analysts, auditors, stockholders, members of audit committees, and students.

Results from this research provide no consistent and conclusive evidence that auditor independence is impaired in fact or appearance by the joint provision of management advisory and audit services. Results of research addressing other factors is also mixed, but does suggest that independence in fact may be affected under some circumstances by certain client pressures and compensation schemes. Results also suggest that financial statement users' perceptions of auditor independence may be impacted by other factors, such as auditor employment with the client, GAAP subjectivity, and the client's financial position.

The SEC has recently called for additional research regarding auditor independence. The Fall 1999 edition of *The Auditor's Report* outlines several areas in which the SEC believes research could be profitably done to contribute to the ongoing dialogue, including the following:

- Do users of financial statements consider nonaudit services provided by auditors to impair auditor independence?
- How does the "materiality" of a financial or family relationship affect investor's views about auditor independence?
- What effect would mandatory rotation of auditors have on actual or perceived auditor independence?
- What factors do users of financial statements consider when assessing whether auditors are independent?

Academic research in auditor independence has received the attention of standard-setters and regulatory bodies. Further research in this area has the potential to contribute to and impact dialogue at the highest levels.

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(Continued on page 8)

Auditor Independence Update *(Continued from page 7)*

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CALL FOR PAPERS

Advances in Accounting Behavioral Research (AABR) publishes articles encompassing all areas of accounting that incorporate theory from and contribute new knowledge and understanding to the fields of applied psychology, sociology, management science, and economics. The journal is primarily devoted to original empirical investigations; however, critical review papers, theoretical analyses, and methodological contributions are welcome. *AABR* is receptive to replication studies, provided they investigate important issues and are concisely written. The journal especially welcomes manuscripts that integrate accounting issues with organizational behavior, human judgment/decision making, and cognitive psychology.

Manuscripts will be blind-reviewed by an associate editor and two reviewers. AABR has now accepts electronic submissions. AABR will send your submission to the associate editor and reviewers via email, which should shorten review times considerably. Please incorporate all text, tables, and figures into a single Word document before submitting. Also, include a separate Word document with any experimental materials or survey instruments. Please send the electronic documents to the following email address: jhunton@coba.usf.edu. Additionally, please send a $25.00 processing fee (make checks payable to AABR/USF) to the following snail-mail address:

James E. Hunton, Editor
Advances in Accounting Behavioral Research
School of Accountancy
College of Business Administration
University of South Florida
4202 East Fowler Avenue, BSN 3403
Tampa, Florida 33620-5500

7TH ANNUAL MIDYEAR AUDITING SECTION CONFERENCE

January 11–13, 2001
Houston, Texas

Your help in planning and conducting the Section's 2001 Midyear Conference is needed. If you are willing to volunteer your assistance in one of more of the following areas, please complete this form and hand it to a Steering Committee member or mail/fax it to the address/number below.

I. Name ______________________________

Address ______________________________

____

City ______________________ State ________ Zip ________

Phone ______________ Fax ______________ Email ______________

II. **Reviewer:** If you are willing to assist by reviewing one to three manuscripts, please indicate your areas of competence/interest.

Research Areas ______________________________

Research Methods ______________________________

III. **Session Chair or Discussant:** Please indicate if you are willing to assist in either of these capacities.

Session Chair ________ Discussant ______

IV. **Special Sessions:** Please provide any ideas that you have for special CPE topics, panels, workshops, etc. If you know any particular individual(s) who may be interested in the areas you recommend, please list their names. Use the back of this page for additional comments.

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The Steering Committee very much appreciates your input. Mail or fax this form to:

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A Comparison of Internal and External Auditors' Choice of Internal Control Documentation Format

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Both internal and external auditors are required to document their understanding of an organization's internal control. For example, SAS No. 78 (AICPA 1995) requires that on every engagement auditors obtain a "sufficient understanding of internal control" to plan the audit and determine the nature, timing, and extent of audit tests. Similar standards exist for internal auditors (IIA 1998). However, no specific guidance exists as to the type or number of formats that should be used for documentation. This article describes differences in the IC documentation formats used by internal and external auditors. In addition, some possible reasons for the observed differences are discussed.

Questionnaire data were collected from 92 external auditors and 69 internal auditors. The external auditors had an average of 42 months of public accounting experience, while the internal auditors had an average of 64 months of internal auditing experience. Participants were asked to indicate any and all formats that they commonly use to document and evaluate internal control. The following table shows the percentage of auditors that use each of the four most common formats:

Format	External Auditors	Internal Auditors	Overall
Narratives	88	85	87
Questionnaires	60	62	61
Flowcharts	47	60	52
Matrices	38	51	43

The results also indicated that internal auditors commonly use an average of 2.5 documentation formats per audit compared with 2.3 formats for external auditors.

While there is little or no difference in how often the two different groups of auditors use narratives and questionnaires, internal auditors tended to use flowcharts and matrices more often than external auditors. These differences may exist for a number of reasons. For example, internal auditors may spend significant amounts of time on the design of the organization's internal control system, whereas external auditors typically would not, unless it is part of a consulting engagement. Moreover, formats such as flowcharts or matrices may be used less often by external auditors because they are relatively costly and time-consuming to prepare. Unlike internal audit standards, external audit standards specifically state that audit costs should be considered when determining the acceptable level of audit risk. Given the current competitive financial audit environment and the formal emphasis placed on efficiency, external auditors may choose to rely on fewer, and less labor-intensive formats than internal auditors in order to minimize internal control documentation costs.

In terms of implications of these results, the differences in documentation format(s) used may hamper the ability of internal and external auditors to communicate effectively with each other regarding internal control matters. Moreover, given the current trend toward outsourcing the internal audit function, external auditors may need to adapt their approach to documenting internal control if they assume the role of the internal auditor. In conclusion, future research could examine if there are significant differences in the internal control evaluations of internal and external auditors, and if these differences interact with the internal control documentation that auditors use.

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The authors would like to thank the Las Vegas and Southern New England Chapters of the IIA for their support, and the internal and external auditors who responded to the questionnaire.

Notable Contributions to the Auditing Literature Award

The Auditing Section seeks nominations for the Notable Contributions to the Auditing Literature Award. To be eligible for nomination, a work must have been published during the five-year period ended December 31, 1999. The award will recognize a published work of exceptional merit that has made, or has the potential to make, a direct contribution to auditing or assurance research, education, and practice. If a work is selected for the award from the nominations made during this first submission period, the award will be presented at the 2001 Midyear Meeting of the Auditing Section.

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Distinguished Service Award goes to Practice Advisory Council

Tom Powell accepts the distinguished service award on behalf of the Practice Advisory Council

At its Midyear Meeting in Newport Beach, the Auditing Section presented its 2000 Distinguished Service in Auditing Award to the Section's first Practice Advisory Council, chaired by Thomas E. Powell, Director of Special Consulting Services for Graham and Cottrill and Chairman of the Powell Group. Tom Powell accepted the award for the PAC, which also included James L. Fuehmeyer, Jr. (Deloitte&Touche LLP), Graham Joscelyne (World Bank), Gaylen Larson (now with the FASB), John D. Miller (Tenneco Management Company), Dennis R. Schueler (now with Schueler Consulting), Joseph T. Wells (Association of Certified Fraud Examiners), and Andrew R. Zaleta (Korn/Ferry International).

The genesis for the PAC was the 1995–96 effort speaheaded by Arnie Wright, then Section President, and Tom Powell, then Director of Professional Practices with the IIA and Section Vice President–Practice. The goal was to improve communications between academics and practitioners. The first PAC meeting was at the August 1996 Annual Meeting.

Over the next three years, this inaugural PAC made several significant contributions to the Section including Midyear Meeting and Annual Meeting presentations—such as the standing room only panel on electronic commerce at the 1998 Annual Meeting—and other opportunities for academic-practitioner interaction, such as the World Bank faculty internship position first held by Section member Jane Mutchler of Penn State.

While the PAC membership will be changing this year, the first group set the model for those who will follow—and set it at a very high standard.

Auditing Literature Award *(Continued from page 10)*

The criteria that will be applied to assess a work's contribution to the auditing and assurance literature are:

- The impact of the work on auditing and assurance research, education and practice;
- The potential of the work to be of interest to a large number of individuals concerned with auditing and assurance research;
- The timeliness and importance of the problem(s) addressed;
- The creativity of the research;
- The development of an appropriate theoretical framework; and
- The appropriateness of the research method and analysis.

To be eligible for consideration, at least one of the authors of the published article, chapter, book or monograph must be a current member of the Auditing Section. Selection of the award winner will be made by the Auditing Section's Notable Contributions to the Auditing Literature Award Committee.

A work may be nominated either by the author or by any other individual with an interest in auditing research, education, or practice. Nominations must include the following materials:

- Five copies of a nomination letter stating why the work is deserving of special recognition
- Five copies of the work

Please send all materials to:

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The deadline for nominations is July 1, 2000. Calendar years covered for this nominating period are 1995 through 1999.

Auditing: Some Current Challenges

David L. Landsittel
AAA 2000 Auditing Section Midyear Conference
January 14, 2000

In developing my comments for today's presentation, I initially outlined many topics and related challenges facing our profession. I quickly concluded that I faced an alternative—to deal with numerous important issues broadly and perhaps somewhat glibly, or to focus on only certain selected issues involving the quality of auditing, but discussing each of those issues in more depth. I concluded on the latter course. Accordingly, I have chosen to address three issues which I believe carry with them current challenges that our profession needs to address in the near future. Areas of focus in my presentation will be:

- Management of Earnings
- Fraudulent Financial Reporting
- Internal Control—Focusing on the Process

In my concluding remarks I will remind you of numerous other important issues that present challenges to our auditing profession, and will also outline briefly my own perspectives as to why I am optimistic about the future of auditing.

Management of Earnings

Many, including the SEC Chairman and the SEC Chief Accountant, have expressed concern about public companies inappropriately "managing" earnings—that is, intentionally recording accounting misstatements in order to adjust reported earnings (up or down)—presumably to obtain a targeted earnings figure or to facilitate an earnings growth that will be viewed favorably in the marketplace.

As this relates to auditing, the concern is that auditors may be too tolerant of such adjustments, rationalizing that the effect is not material, even though the management action itself might be considered *prima facie* evidence of a management concern that its reported results would otherwise result in an undesirable investor response.

Following from this concern is also the observation that given the high market price-earnings multiples currently existing, even a penny-a-share deviation in reported earning compared with analyst expectations is likely to trigger an investor response that could affect market capitalization by millions of dollars. Accordingly, the view is that auditors should adjust their judgments about materiality to recognize the sensitivity of this current market environment.

A number of current initiatives have been undertaken in response to this concern. First, with the Big 5 firms serving as a catalyst, the Auditing Standards Board has recently approved a new auditing standard dealing with how unbooked audit adjustments are communicated—assuring that top management and the audit committee are specifically aware of unrecorded adjustments and that management is responsible for concluding in its representation letter to the auditors that the effect is not material. The overall goal of this approach is to encourage the recording of proposed audit adjustments, eliminating the need to evaluate whether their effect is material [*editor's note*: see discussion of this standard, SAS No. 89 in the ASB Update].

Second, the Big 5 firms have each agreed to incorporate into their audit policy guidance as to the kinds of "qualitative" factors to consider in evaluating the materiality of proposed adjustments. Generally accepted auditing standards require the auditor to consider qualitative (as well as quantitative) factors in evaluating materiality, but offer few examples of the specific qualitative factors that should be considered. The Big 5 guidance is now available on the AICPA web site for others, and the ASB has indicated an intent to incorporate similar guidance into the auditing literature.

Relatedly, the SEC has issued SAB 99 discussing materiality. While this guidance has controversial elements, it contains discussion about the qualitative factors to consider in evaluating materiality that is reasonably consistent with what the Big 5 guidance presents. In addition, importantly, SAB 99 is also helpful in encouraging registrants to record proposed audit adjustments.

Finally, important audit research has been conducted under the direction of Professor Bill Kinney of the University of Texas, examining "earnings surprise." Its conclusions do not appear to support the notion that the current market environment is so different as to require a fundamental change in how auditors view materiality.

Notwithstanding the initiatives outlined above, the concern about the management of earnings, in my view, triggers a number of challenges that the auditing profession should further address.

Challenge No. 1: Aggressively working to eliminate/minimize any unrecorded audit adjustments.

The best way to attack any concern, whether warranted, about auditors being too tolerant of intentional management misstatements to "manage" earnings is to aggressively push to eliminate the acceptance of misstatements in the first place. While the new auditing standard dealing with audit adjustments and the SEC's new SAB 99 provide tools to help arm the auditor in this regard, it is up to the profession to actually use these tools effectively. The profession needs to communicate with management and the audit committee by very explicitly calling attention to unrecorded audit adjustments, no matter if they are seemingly immaterial. In this regard, auditors should challenge management to justify the acceptability of not recording proposed audit adjustments. If they are indeed immaterial, the marketplace effect is inconsequential and recording them would not produce an adverse investor response.

Challenge No. 2: Seeking more consensus on what constitutes a material adjustment.

I previously mentioned the profession's efforts to define more

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specifically qualitative factors that should be taken into consideration in evaluating materiality. Interestingly, there are also significant differences in how different firms and individual professionals evaluate materiality from a *quantitative* point of view. Let me explain three dimensions of these differing approaches.

First, different firms and professionals view differently what the quantitative threshold that establishes a presumption of materiality should be, absent any qualitative factors that would affect the materiality evaluation. As a small anecdotal experiment along these lines, I asked seven very knowledgeable and experienced audit practitioners the following: Assuming (1) you are dealing with a company where the best measure of materiality is the effect of a misstatement on net income, and (2) no qualitative factors would come into play, what is the largest percentage misstatement that the auditor could accept without having to qualify the audit report. The answers varied from 3 percent to 10 percent, (with a few offering ranges of 3 to 8 percent or 5 to 10 percent without being willing give one specific percentage). The point is that the profession would be well served in closing this gap in differing views as to a percentage misstatement that would be presumed to be material before the consideration of qualitative factors that might affect this initial materiality determination.

Second, there are differing views on how the effect of a misstatement on prior years enters into the measure of the materiality of a misstatement. As an example, assume an audit client needs an inventory obsolescence reserve. The shortfall is $1,800 at the end of the current year, and was determined to be $1,500 at the end of the preceding year. Some argue that an evaluation of materiality would measure the misstatement as being $1,800 since, under GAAP, to record the adjustment to fix the problem would result in a charge to current income of $1,800 (as the effect in the prior year was previously assessed as immaterial eliminating the opportunity for restatement). Others would measure the misstatement as $300 since the “real” effect on current income would be the difference between the current year’s and the preceding year’s reserve shortfall.

A third significant difference in practice arises in evaluating the effect of misstatements on interim periods. Some say that the evaluation of interim misstatements should be measured solely by considering the effect on the given interim period, while others believe that the effect should in some way be annualized. For example, assuming a company otherwise earns $1 million per quarter, should the materiality of a $100,000 interim misstatement be evaluated against $1 million or against the $4 million annualized income amount (as would be done in the annual audit)?

Still another controversial area in measuring materiality involves a determination of management’s motive—specifically, does the misstatement arise because of management motive to “manage” earnings? Should a misstatement that otherwise might be deemed quantitatively and qualitatively immaterial be viewed as unacceptable because of such a management motive? The guidance in SAB 99 would seem to say so. And, of course, the underlying premise might be viewed as a contradiction since how could the misstatement otherwise be “immaterial” if, in fact, it did arise because of a desire by management to “manage” earnings—for example, to meet analysts’ expectations. The difficulty to the auditor arises, of course, in evaluating management’s motives.

> *Challenge No. 3: Obtaining further understanding as to whether marketplace environmental changes should affect materiality decisions.*

I previously mentioned Bill Kinney’s very insightful research about “earnings surprise”—that is the effect on investor decision making of differences between reported earnings and the analysts’ most recent consensus estimates of such earnings. The research tentatively concludes that investors’ decisions have not been fundamentally affected over time by such environmental factors as high market capitalization and P/E ratios and increased prominence of comparing reported earnings against analyst consensus figures. In fact, the research notes that other factors that emerge at the time of the earnings announcement have resulted in an investor response that is contrary to the direction of the “earnings surprise” 46 percent of the time.

I don’t have time to get into more detail about the above research here, except to say that an ongoing issue remains whether the auditor’s materiality judgments are aligned with investor decision making. Would some misstatements evaluated as “immaterial” by management and auditors, in fact, affect investor decision making if recorded, and conversely, do some issues that are concluded to be “material” really have little or no significance to the investor. Kinney’s research presents conclusions that should be the subject of further validation and also presents specific suggestions for further research—addressing the overall issue as to whether materiality decisions by management and auditors are properly aligned with investor decision making in today’s environment.

To summarize the management of earnings arena, whether the concern that auditors are too lenient in permitting inappropriate management of earnings is valid, nevertheless, the profession should: (1) work harder to get management to record even immaterial proposed audit adjustments; (2) come to a further consensus on how to measure what constitutes a material misstatement; and (3) support further research on whether the auditor’s evaluation of what is material aligns with investors in today’s marketplace.

Fraudulent Financial Reporting

Now let’s turn to the second area I would like to examine—fraudulent financial reporting. Of course, as you recognize, there is a relationship here with my discussion of management of earnings. Management of earnings suggests “tinkering” with earnings to achieve a more favorable reporting outlook, but with a presumption that the financial results are not materially misstated or fraudulently misrepresented. But, “tinkering” leads to “cooking.” Typically, fraudulent financial reporting starts out small with no intent to deceive, but grows over time as the pressures build until it is full-blown “cooking the books.”

Fraudulent financial reporting is harmful in so many respects. It undermines the marketplace confidence in financial reporting and in the quality and usefulness of audits. It often results in

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huge litigation costs. It destroys careers. And it sometimes precipitates excessive regulatory intervention.

Over recent years, the auditing profession and others have been reasonably aggressive in addressing the concerns in this area. Most significantly, SAS No. 82 was issued a couple years ago, with a goal of sensitizing and clarifying the auditors' responsibilities for detection of material misstatement due to fraud and providing a framework for the auditor to use in meeting these responsibilities.

Other steps have more recently been taken. For example, the Big 5 firms have now voluntarily initiated policies that require that "timely" interim reviews be made for all of their publicly held clients. This initiative has now been supported by an SEC proposal for regulation to require "timely" interim reviews. This is important as fraudulent financial reporting often begins with interim periods—sometimes without the cover-up of tracks that would take place before the annual audit. Timely interim reviews should help auditors detect material misstatement due to fraud.

Some of the current initiatives extend beyond the auditing profession. For example, the National Association of Corporate Directors has released two booklets that address audit committee "best practices," one of which specifically provides guidance on the audit committee role relating to the risk of fraudulent financial reporting. In addition, there has been a marked increase in research in this area. Most notably, the Committee of Sponsoring Organizations (COSO) has released a study of fraudulent financial reporting occurrences, investigated by the SEC between 1987 and 1997, that has produced some insightful findings and implication. I know some of you are actively involved in audit research in this important area.

But, in an environment that demands continuous improvement, there are some important challenges for the auditing profession to address dealing with fraudulent reporting.

Challenge No. 4: Joining with other financial reporting stakeholders in spearheading advances in fraud prevention and deterrence best practices.

Interestingly, while there have been individual initiatives by accounting firms and others to provide insights on prevention and deterrence of fraudulent financial reporting, not since the Treadway Commission in 1987 has there been a significant joint effort among financial reporting stakeholders to significantly advance the thinking in this area. Additionally, the commentary I have read on this topic often deals with prevention and deterrence narrowly, for example, solely the role of the audit committee or the internal auditor in addressing fraud prevention safeguards.

Since Treadway, there has been some interesting information published on the root causes of fraud. For example, the "Fraud Triangle" outlined by Professor Steve Albrecht of Brigham Young University persuasively notes that all frauds are "ignited" through the combination of three ingredients or root causes: (1) a "pressure" (e.g., pressure to meet profit expectations or to maintain or increase stock values), (2) an "opportunity" (i.e., a lack of internal control over financial reporting), and (3) a "rationalization" (i.e., compromised ethical reasoning justifying the fraud). We need to update the Treadway thinking with a major study—the various financial reporting stakeholders joining forces to study the root causes and develop and publish "best practice" guidance with a goal of meaningfully advancing the "state of the art" in the prevention/deterrence of fraudulent financial reporting.

In this regard, a specific area that I believe warrants particular attention in the fraud prevention arena is the process management follows in addressing analysts' expectations. If management can be more effective in communicating in the marketplace to assure that analysts' expectations are aligned with expected financial results, the pressure to "tinker" or "cook the books" to eliminate what would otherwise be an undesirable earnings surprise will be mitigated.

Challenge No. 5: Taking auditing guidance and standards on fraud (SAS No. 82) to the next level.

One important message that accompanied the release of SAS No. 82 in late 1997 was that its issuance was not intended to be "the answer" to the concern about the auditor's responsibilities and performance in detecting fraud. Rather, it was an important step in an ongoing process of seeking continuous improvement in how auditors address their role in detecting material misstatements due to fraud. Consistent with that approach, the AICPA has subsequently sponsored some important audit research in this area.

In moving forward to the next level, some important issues that I believe need to addressed are as follows:

- Improving the fraud risk factor identification process. Are we evaluating the "right" risk factors? Can the risk factors be developed into a model or otherwise weighted and scored?
- Sharpening the linkage of identified risk factors with the resulting audit program modifications that may be needed. Some research has called into question whether auditors are effectively modifying audit program steps to appropriately address fraud risk factors they have identified as being "in play."
- Sharpening the inquiries of management about fraud and fraud risks. Are we making inquires of a broad enough management/ employee group? Are the inquiries too glib or broad in nature?
- Incorporating today's technological environment into the guidance about fraud risk evaluation. SAS No. 82 does not address in depth today's technology, both in terms of control systems and in terms of the risks that e-business activities generate.
- Recognizing the possible use of new "out-of-the-box" fraud detection techniques. For example, research has indicated that the most frequent way in which fraud is detected is through employee "whistle blowing." Should auditors take the lead in facilitating enhanced communication with employees–e.g., establishing "hot-lines," or sending survey inquires to a wide ranging sample of employees?
- Sponsoring the conduct of additional audit research to evaluate the results of SAS No. 82 implementation, including

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validating (or refuting) the premises underpinning the SAS No. 82 "how-to" risk assessment approach.

> Challenge No. 6: More systematically addressing how to add assurance that audit work is accompanied by the necessary "professional skepticism."

Often, it is noted in after-the-fact evaluations of undetected fraud that had the auditor simply asked that one additional question, or carried out that one additional audit step in response to a warning signal, the fraud may have been detected. In almost every instance of alleged auditor failure to detect material misstatement due to fraud, the lack of necessary "professional skepticism" has been asserted.

The auditing literature and the reference and training materials of the various auditing firms exhort the need for "professional skepticism." The guidance contains all the right words. But the environment in which the auditor operates contains so many factors that work against a goal of always assuring that sufficient "professional skepticism" exists. For example, the auditor almost always conducts the work under some time pressures and deadlines; the auditor wants to maintain good relations with the client and accordingly may be reluctant to challenge management when necessary; and most auditors have never experienced material fraud first-hand and accordingly may be overconfident in presuming its lack of existence.

The profession needs to invest additional profession-wide resources to systematically address this concern. This should include looking outside the profession for guidance; for example, engaging behavioral scientists to assist in a study of the issues. To my knowledge, notwithstanding the importance of "professional skepticism" to audit success, never has a major profession-wide investment been made to assure it is adequately maintained. We need substance, not simply the "right words."

In addressing the professional skepticism concern, one often proposed specific action that I would also endorse is training to improve auditor interviewing skills. While the auditor, in my view, cannot adopt an unduly aggressive or accusatory interviewing style in a normal audit, there is a balance. Auditors are often too polite in accepting responses to inquiries without the necessary follow-up questions when exception or inconsistencies seemingly emerge.

> Challenge No. 7: Developing an improved way to learn from past fraudulent financial reporting cases.

For a number of years the AICPA has had a process in place, under the direction of its Quality Control Inquiry Committee (QCIC), to examine whether allegations of audit failure result from the existence of systemic weaknesses that should be addressed. Historically, this process has focused for the most part on individual cases and the assessment of whether there are issues arising from an examination of the specific case facts.

Some have criticized the QCIC process as being too slow; and some also believe that the individual case findings are not well publicized in order to bring public closure. While quicker review and wider dissemination of results may be advantageous, in my view, future changes in the QCIC process should include a more thorough longitudinal review extending beyond the focus on a given case. More effort needs to be given to identifying common trends and environmental factors existing across a number of cases that would be helpful in identifying profession-wide "root causes" of auditor nondetection of material misstatement due to fraud.

Recently, QCIC has developed a method of accumulating (on a "no-name" basis) a limited database of case information that should assist in a focus that extends beyond the individual case-by-case facts. Hopefully, this will be a step in the right direction.

Internal Control–Focusing on the Process

The final area I want to discuss with you this morning is internal control. In my view there are two separate but related problems that need to be addressed.

The first is my concern that the auditor does not have the ability to effectively assess the quality of the internal controls in place. There are two reasons for this. The first is a lack of skill and training. Many auditors are inherently good at focusing on results, but not so skilled at process-related evaluations. Second, and perhaps more important, some control elements are not readily capable of assessment—particularly by an "outsider." In particular, two critically important facets of controls fall into this category—evaluating the "tone at the top" and evaluating the sufficiency of controls at owner-managed companies where the ability to override exists almost by definition.

The second problem is this: The auditor does not assess controls as thoroughly as the investing public assumes. As you know, generally accepted auditing standards require only a limited evaluation necessary to plan the audit including the scope for testing. On the other hand, when an auditor gives a "clean opinion," most readers presume that this gives a stamp of approval not just to the financial statements presented, but also to the processes that underpin that reporting. In fact, studies have indicated that the latter may be valued more highly than the former—that is, investors already are aware of the financial results, prior to their presentation with the auditor's report a month or two after year-end. The value of the auditor involvement is in the confidence it provides implicitly that the client's financial reporting process can be relied upon in future disclosures, both interim and annual.

As you recognize, the two problems described above become more tenuous when considered together. You can't solve the latter problem—the investor misunderstanding of the extent of the auditor's assessment of controls—if there is inherent difficulty in making such assessments even if the additional work were to be performed.

> *Challenge No. 8: Working with other financial reporting stakeholders, further improve the "state of the art" of controls and control assessments.*

Auditing standards, the Treadway report, the COSO internal control guidance and other sources present a reasonably coherent sketch of the elements that need to be in place to assure an appropriate "tone at the top." The same is true, although to a more limited extent,

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regarding owner/managed company controls. The problem is that the criteria presented in this material include "slippery" elements that are hard to evaluate. As a result, what appears to be a company with strong controls and "tone at the top," may be one where subsequent financial reporting difficulties will result in an after-the-fact assessment that the controls and "tone at the top" were, in fact, deficient.

To assure the ability of the auditor to develop an effective evaluation of the control elements noted above, the criteria need to be sharpened, so that tangible deficiencies can be recognized before-the-fact and not solely when a financial reporting problem has arisen. The profession needs to work with management representatives, internal auditors, and others in advancing the knowledge and thinking in this important area.

Somewhat related, as I will note in discussing the next challenge, the need to further strengthen the "state of the art" of controls and control assessment becomes more urgent in the "new economy." There is a new dimension to the business risks that needs to be controlled, one that further extends beyond the boundaries of traditional financial reporting inasmuch as the assets and activities to be controlled include more elements not accounted for in the traditional accounting model.

Challenge No. 9: Developing an approach to encourage and facilitate auditor reporting on controls.

In order to better align the auditor's involvement in control assessments with investor expectations, auditors need to devote additional resources during an audit to the evaluation of internal control. Auditor control reviews sufficient to enable a report on controls would be one way to accomplish this. Such reporting has been advocated previously by the Big 5 firms and the AICPA, and at least one firm more recently reiterated that recommendation. Briefly, the benefits are as follows:

- It would make the auditor's role in control evaluation unmistakable to the investors. The objectives and extent of the auditor involvement would be explicitly defined and disclosed in the auditor's report on controls.
- It would add credibility to management reporting on controls.
- It would provide more opportunities for auditors to make recommendations and work with management to improve controls.
- It would assist audit committees in fulfilling their oversight role relating to an evaluation of the adequacy of controls.
- It would facilitate a transition to a new reporting model—that is, continuous reporting and auditing the assets of the "new economy."

Regarding the last point, an Arthur Andersen presentation to the Public Oversight Board Panel on Audit Effectiveness recently noted that in 1978, the book value of all publicly traded companies equaled 95 percent of market value. Today it is only 40 percent. Stated another way, our current accounting model today does not account for 60 percent of the assets valued in the marketplace by investors. An important first step toward a continuous reporting model that would include some assurance on the assets of the "new economy" would be accomplished by auditor reporting on the control process, not merely limiting the focus to a report on results at a particular point in time following the traditional GAAP model.

Other Audit Challenges and the Future Outlook

I have presented above nine audit challenges that evolve from my discussion of three specific areas important to audit quality. I don't want to imply that there are not other, equally important, audit challenges. Without meaning to be all inclusive, some that come to mind include: (1) working to add assurance to global audit quality; (2) developing criteria and standards to provide a better basis for auditing "soft" assets (including some of the assets of the "new economy" discussed previously); (3) improving audit committee effectiveness as an audit quality safeguard; and (4) attracting the "best and brightest" to our auditing profession.

With such a daunting number of challenges, doesn't this call into question the very viability of auditing and our profession? To the contrary, I believe the future is bright. To support my view, I want to first diffuse a few "myths" and then briefly note some marketplace trends that will only increase the need for and value of our auditing services.

First the "myths":

- "There is no growth in audit services"—but recent financial data indicates that audit growth in many firms is currently double-digit.
- "Auditing is a loss leader"—but in my former firm, assurance services are as profitable as tax and consulting.
- "Auditing is a neglected service"—but the level of investment by firms in new audit methodologies, tools, and competencies is currently very significant.
- "Audits provide little value in the marketplace"—but research provides evidence that the aggregate reduction in the cost of capital resulting from audited financial information far exceeds the aggregate of the related audit fees.

Current trends in the marketplace suggest that in the future the marketplace will need assurance services more than ever. Specifically: (1) *new technology* adds new dimensions that accelerate concerns that information is reliable; (2) *globalization* drives the need for capital markets to be more transparent; (3) *changing business relationships and structures* increase the need for added accountability; and (4) the "new economy" is generating increases in information and assets that will demand assurance of reliability.

To summarize, the outlook for auditing is bright. If we can successfully address the many challenges that we face—and our profession's track record suggests that we can and will—our profession's viability will be even further strengthened and assured.

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Revised Manuscripts Deadline: September 30, 2000
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HAVE YOU SEEN...?

Troy Hyatt, Seattle University, and Brad Reed, University of Southern Illinois–Edwardsville

"Reinventing Auditing, Redefining Consulting and Independence," by K. K. Jeppesen, *The European Accounting Review* (Vol. 3, No. 7, 1998): 517–539.

A brief history of the evolution of the audit process is given, resulting in a discussion of the current focus of the large auditing firms to reinvent the audit process. It is argued that the efforts of the audit firms to change the audit process, (e.g., KPMG's business measurement process and Ernst & Young's audit innovation project) have changed auditing into consulting. The authors argue that the audit has been changed to consulting because of the focus of these new audit methodologies on adding value to the auditee. To add value, auditors now focus on understanding the auditee's strategies and goals, and focus the efforts of the audit on helping the audit client achieve its strategies and goals. This shift in the audit process makes the auditor an interested participant in the auditee's performance, thereby impairing independence. The authors further argue that it is therefore impossible for the auditor to be independent since auditing is no longer an independent discipline.

"Error Cost and Auditors' Termination Decisions," by K. Menon and D. D. Williams, *Journal of Accounting, Auditing and Finance* (Vol. 14, No. 2, 1999): 95–122.

The apparent recent phenomenon of auditors resigning from clients is examined in this paper. First an analytical model of the auditor's decision process is presented that shows that the auditor will resign from engagements when the expected cost of undiscovered audit errors becomes large. This cost reflects both the likelihood of client misrepresentations and the expected losses if these misrepresentations are revealed. Data is gathered that provide support for the analytical model that is presented. The authors also explain why auditors would be willing to retain potentially risky clients. The authors assert that some auditors may believe that they can economically reduce detection risk in such situations because of their industry expertise and prior engagement experience (auditor tenure). The data shows that auditors are less likely to resign from engagements where they have strong industry expertise or when they have lengthy tenure with the client.

"Internal Controls and the Detection of Management Fraud," by D. Caplan, *Journal of Accounting Research* (Vol. 37, No. 1, 1999): 101–117.

This paper examines the auditor's decision to investigate for fraud when a manager with incentives to misreport chooses the quality of internal controls. The auditor's decision regarding fraud investigation is made under uncertainty with significant economic consequences dependent upon the choice. Because routine audit procedures may not distinguish between errors and fraud, an auditor who suspects fraud must perform a costly investigation to learn if fraud occurred. If fraud exists, but the auditor fails to investigate, subsequent discovery of the fraud is costly to the auditor. The author shows that given this decision set, it may be rational for the auditor not to audit intensively for fraud, even when controls are weak. This result arises because a weak control system generates more errors than a strong system, increasing the probability that a given audit exception is due to error. However, the author also shows that because managers might choose weak controls in order to "hide" fraud, the use of control strength as a "red flag" in fraud risk assessments is reasonable.

"Auditors' Hypothesis Testing in Diagnostic Inference Tasks," by C. E. Brown, M. E. Peecher and I. Solomon, *Journal of Accounting Research* (Vol. 37, No. 1, 1999): 1–23.

This paper performs two experiments on auditors to examine the following questions: (1) Do auditors adapt their hypothesis tests to changing logical relations between their hypotheses and truth? (2) Do auditors use hypothesis tests possessing greater expected diagnosticity? (3) Do auditors ascribe appropriate expected diagnosticities to specific hypothesis tests? The authors find that auditors do change their hypothesis tests to changing logical relations between their hypotheses and truth and that auditors use hypothesis tests with high expected diagnosticity. The authors also find that auditors who hypothesize auditee explanations to be true ascribe inappropriate diagnosticities to specific questions. Incentives are also found to influence properties of these inappropriate diagnosticities.

"The Auditor's Going-Concern Disclosure as a Self-Fulfilling Prophecy: A Discrete-Time Survival Analysis," by T. J. Louwers, F. M. Messina and M. D. Richard, *Decision Sciences* (Vol. 30, No. 3, 1999): 805–824.

This paper evaluates the possibility that a going-concern opinion from an auditor is a self-fulfilling prophecy of the auditee's bankruptcy. The authors also introduce the use of Discrete-Time Survival Analysis (DTSA) to examine the aftermath of 231 first-time going-concern disclosures on clients' subsequent continuance. DTSA represents a refinement over traditional ordinary least squares and logistic regression in that it provides not only a probability estimate, but also an estimate of the timing of the event occurrence. Consistent with the "self-fulfilling prophecy effect" the risk profiles developed from DTSA indicate that the first year subsequent to the initial going-concern disclosure was the most dangerous in terms of risk of bankruptcy. However, DTSA shows that 27 percent of the companies that received initial going-concern disclosures failed in the subsequent year and that recipient companies survived for approximately four years, on average, after

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receiving one. Thus the authors note that DTSA provides evidence that going-concern disclosure is only weakly associated with imminent client insolvency, allowing auditors to focus on the appropriateness of the disclosure without overly concerning themselves with whether the disclosure will drive the client into bankruptcy.

"The Formation and Role of Reputation and Litigation in the Auditor-Manager Relationship," by S. Datar and M. Alles, *Journal of Accounting, Auditing & Finance* (Vol. 14, No. 4, 1999): 401–428.

Due to the Private Securities Litigation Reform Act passed by Congress in 1995 and other recent court decisions, the potential liabilities that auditors face from lawsuits claiming auditor negligence have been reduced. The reduction of auditor liability has led some to argue that audit quality would be reduced because of the reduction in auditor liability. This paper uses an analytical model to show that changes in the auditor liability environment will not result in a decrease in audit quality because of the auditor's desire to maintain a reputation for diligence. This paper analyzes auditor reputation in the internal setting in which a firm's audit committee wishes to validate the statements of its managers, rather than the usual external setting in which auditors attest to a firm's financial reports. In this setting the explicit objective of auditing is to proactively deter misreporting by the manager. The manager can forecast future auditor behavior only on the basis of past auditor behavior. This motivates the auditor to perform in a high-quality manner to deter misreporting by the manager. The motivation for auditors to form quality reputations reduces the fear that recent reductions in auditor liability will lead to a decline in audit quality.

"Audit Pricing and the Role of Multinational Factors: A Study of the Hong Kong and Malaysian Markets," by A. M. Rose, *Advances in International Accounting* (Vol. 12, 1999): 129–155.

This paper investigates audit fee determinants in Hong Kong and Malaysia. Relying on prior audit fee research and the theory of the multinational enterprise, the author develops and tests five hypotheses using 1995 data. After controlling for client size, audit complexity, and audit risk, the following results were found: (1) Big 6 firms charge an audit fee premium across all clients in Hong Kong but not in Malaysia; (2) auditors in both Hong Kong and Malaysia charge higher audit fees to clients of increasing multinationality; and (3) a dual market for audit services based on the multinationality of the client exists in Malaysia but not in Hong Kong. In other words, Big 6 firms in Malaysia are able to charge a fee premium to multinational clients but not to domestic clients. The author argues that the differing results for Hong Kong vs. Malaysia are due to differences in the business environment between a developed country (Hong Kong) and a developing country (Malaysia). Possible areas for future research include identifying additional measures of multinationality (to validate the robustness of the current study's results) and extending the analysis to other countries in other regions of the world.

"The Coupling of the Symbolic and the Technical in an Institutionalized Context: The Negotiated Order of the GAO's Audit Reporting Process," by O. N. Basu, M. W. Dirsmith, and P. P. Gupta, *American Sociological Review* (Vol. 64, No. 4, 1999): 506–526.

The purpose of this paper is to examine the nature of the relationship between the GAO's technical work (the work it actually performs backstage) and its externally directed symbolic displays (the image it presents to external parties) as they relate to the GAO's audit reporting process. This relationship has been examined in various organizations and is unresolved. One group of organizational scholars believes that these two facets of organizations should remain disconnected from one another as they are fundamentally different and any link between them could contaminate one or the other. Another group of organizational scholars believes that the two facets are inseparably connected through complex interrelationships. The authors of the current study investigate this relationship as it relates to the GAO's audit reporting process through use of a qualitative field study, consisting of interviews augmented with archival analyses. Results indicate that the GAO's internal work and the image it presents to external parties, such as the Congress, the press, and the federal agencies it audits, are indeed complexly interconnected. Results also suggest that the strength of these connections is influenced by the relative power of the external parties with which the GAO interacts. The paper concludes by suggesting opportunities for future research in various types of organizations.

"Determinants of Audit Fees: The Importance of Litigation, Disclosure, and Regulatory Burdens in Audit Engagements in 20 Countries," by M. H. Taylor and D. T. Simon, *The International Journal of Accounting* (Vol. 34, No. 3, 1999): 375–388.

This study examines the effects of variation in the overall macro-economic/political environment that exists across countries on the market for audit services. Prior research on audit fees has focused almost entirely on audit client characteristics, such as client size, audit complexity, audit risk, and client industry, variables that the authors refer to as micro-economic variables. The current paper combines audit fee observations from 20 countries into a single sample. This approach allows the authors to investigate the effects of litigation, disclosure, and regulatory burdens, which vary across but not within countries, on audit fees. The sample consists of over 2,300 observations from audit engagements in 20 countries during the period 1991 to 1995. After controlling for the above-mentioned audit client characteristics, results indicate that increased litigation pressures, institutional traditions of increased disclosure, and increased regulation are each important determinants of audit fees. The paper's results indicate an important role for macro-economic variables in audit fee research and point to the need for future research.

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Have you Seen? *(Continued from page 19)*

"Governmental Accounting and Auditing in Thailand: An Overview and Some Suggestions for Improvement," by L. J. Henry and P. Attavitkamtorn, *The International Journal of Accounting* (Vol. 34, No. 3, 1999): 439–454.

Frequently, governments, including Thailand's, make resource allocation decisions with poor-quality financial information that is not reliable, not timely, and limited in its data on assets and liabilities. In May 1997, Thailand experienced an economic crisis that required the intervention of the International Monetary Fund, led to the collapse of the Thai government, and seriously damaged the Thai economy. The purpose of this paper is to present the current state of governmental accounting and auditing in Thailand, which the authors conclude is rudimentary at best. In addition, the authors make several suggestions for improving the reporting and auditing of financial information in Thailand. Given the current economic crisis in Thailand, the need for informed decision making, based on quality financial information, has never been greater.

Professor Nicholas Dopuch Receives the Outstanding Auditing Educator Award at the Auditing Section's Midyear Meeting in Newport Beach

Neurobiologists speak of a particular behavior in the brain that they call "spreading activation." When stimuli are received by the brain, a series of chemical and electrical reactions and interactions cascade across a massive web of neurons, and when all is said and done, the entire system has changed. "When I think about the impact that Professor Dopuch's career has had on auditing education, the analogy that comes to my mind is "spreading activation," said Past President Tim Bell at the Auditing Section Midyear Meeting Awards Luncheon. "I can say with certainty that Nick Dopuch has had a significant positive impact on the professional lives of everybody sitting in this room today."

Professor Dopuch has made a positive impact on auditing education through his:

- supervision of doctoral students specializing in auditing—scholars who have gone on to make their own significant impacts on students and peers;
- mentoring of junior faculty during those critical early career years;
- advice, nurturing, and demand for rigor in his capacity as editor of the *Journal of Accounting Research* when he influenced a large body of scholarly work in auditing;
- fostering the evolution of the audit judgment and decision-making research paradigm;
- many research publications in the field of auditing.

The influence of Professor Dopuch's life's work will continue to spread through the profession, activating and exciting others in perpetuity.

We the members of the Auditing Section of the American Accounting Association congratulate this year's recipient of the Outstanding Auditing Educator Award—Professor Nicholas Dopuch.

Incorporating Changes in the Audit Process in the Classroom

Mark E. Peecher
University of Illinois at Urbana–Champaign

We hear it all the time: "Business is changing at an increasing rate." The velocity of change shifts how organizations do business and generate value. One can assert that conventional market valuation and financial reporting models are losing relevance. Skeptics of this assertion should note that even slow-to-appear archival/empirical research provides considerable evidence that, over time, GAAP fossilization with respect to the handling of intangibles has deteriorated the relevance of financial statements (see, e.g., Lev and Zarowin [*JAR* 99]). Though I ping-pong between being optimistic and pessimistic about the future of statutory financial statements, I have steadfast and high confidence in the future of assurance services.

Among reasons for my confidence is that the Big 5 and others have extensively re-engineered how they conceptualize and perform assurance services. Several of the largest firms have implemented dramatic changes in the financial-statement audit process. These changes reflect the emergence of "Strategic Systems Auditing" (SSA). A striking thing about SSA is that it may be well suited for gathering diagnostic audit evidence *and* capable of generating value (from an assurance perspective) that, if necessary, can be divorced from statutory financial statements.[1]

Because of SSA's increased pervasiveness, I cover SSA cases within my conceptually oriented assurance course—a course that is not focused on GAAS or other standards. I also believe that these cases could fit within traditional financial-statement auditing courses—even courses primarily focused on GAAS. The SSA cases are outstanding pedagogical materials made available to us through the KPMG/UIUC *Business Measurement Case Development and Research Program*. Under this program, world-class accounting and strategic management faculty from diverse institutions author cases with the collaboration of professionals from KPMG and its client organizations. Your students will be amazed to learn the cases are free to them. You can gain access to the cases and teaching notes by clicking your mouse (http://www.cba.uiuc.edu/kpmg-uiuc/index.html). You may find these two advantages striking given that my experiences with the cases have been very positive.

You should be forewarned about one thing. Each case will require considerable investment on the part of your students and even more on your part. Assuming some familiarity with SSA, mastering the teaching notes may take a good long day (or two). Your investment and that of your students, however, offer high rates of return. My students and I became more knowledgeable of auditing reality, my students won points with interviewers, and I became better equipped to conduct meaningful auditing research. The three cases that I used (summarized below) were intricately detailed, fraught with real-world ambiguity, and illustrated how auditors develop financial-statement expectations that incorporate (but transcend!) "last year's financial statements."

I first used the Loblaw Companies Ltd., case because Loblaw competes in a familiar industry. It is Canada's leading retail grocery chain and is exhibiting double-digit revenue growth despite being in a flat-revenue industry. My students analyzed Loblaw's strategic positioning, and they learned how auditors leveraged knowledge about Loblaw's supply chain management processes to audit financial-statement assertions about inventory. In particular, Loblaw's *low-cost leadership* strategy, which requires low (high) distribution costs (efficiencies), provides a basis to expect cost and efficiency performance measures that fall well below (above) industry norms. Verification of these performance measures through multiple interviews, benchmarking studies, and analytical procedures helps test Loblaw's assertions for inventory (e.g., existence, completeness, and valuation). Because of low audit risk, Loblaw's auditors reduced "traditional" substantive testing for inventory. And, they tailored any such tests that they did perform based on where residual risks existed (i.e., they wanted to reduce the obsolescence risk at warehouses but not at individual stores because it was quite unlikely that material amounts of obsolete inventory would accumulate at stores).

Next, I used IDEC because it is a "research & development" biopharmaceutical firm that exemplifies my earlier comments on business change and the "relevance lost" of financial statements. IDEC, who developed Rituxanä (a preferred treatment for certain forms of non-Hodgkins lymphoma), relies on a number of alliances to generate value. Students come to understand that IDEC's prospects hinge more on risks associated with its strategic alliances and the FDA approval process than on more traditional predictors of value (previous quarters' earnings). IDEC outsources its production arm so that it can focus on research and development. So, its future depends on securing top researchers and on alliances partners' fulfillment of their contractual obligations (production, marketing, and distribution). Revenue streams that are crucial for IDEC may mean less to its larger alliance partners, who might not exert best efforts. The FDA could reject IDEC's next "star" drug that currently is in the R&D pipeline (and simultaneously approve a competitor's drug that treats the same diseases). If risks such as these were realized, IDEC's access to attractive alliance partners and human talent would diminish while its cost of capital would increase. All these would reduce IDEC's ability to generate value.

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[1] As an example, market participants clearly want assurance on information regarding organizations' awareness and management of business risks. The SSA approach heavily focuses on such risks and on organizations' strategy for managing them. Although some regulatory interest exists in broadening the disclosure of such risks within financial statements (e.g., see, "Financial Reporting of Risk: Proposals for a Statement of Business Risk" at http://www.icaew.co.uk/depts/td/tdfrc2/risk/), the future roles of financial statements with respect to such disclosures are unsettled.

Incorporating Changes *(Continued from page 21)*

After two confidence-building rounds with SSA cases, I invited two auditing professionals who specialize in banking and financial services to facilitate class discussion on the Wells Fargo case. This case focuses on business-to-business electronic commerce. The class discussion was great as students quickly came to realize that an organization's ability to harvest profits from traditional services does not necessarily provide auditors with forward-looking comfort. For banks like Wells Fargo, auditors must take into account rapidly emerging e-commerce because its affects the adequacy of current disclosures and future earnings (i.e., organizational viability).

To close, I think we can add tremendous value to our students' accounting education by challenging them to learn and apply SSA principles. The three SSA cases I briefly summarize here are largely stand-alone products. I found them to be accessible to my students, and I found that the cases' teaching notes answered almost all my class delivery and substance questions. On some instances, I would have to study some chapters in books, articles, or web sites that were referenced in the teaching notes as being "for further reading." In retrospect, most of these instances stemmed from to my need to get up to speed on strategic management theories and issues—both of which barely were on my radar screen a few years ago.

CALL FOR PAPERS

University of Illinois Symposium on Auditing Research

The Fourteenth University of Illinois Symposium on Auditing Research will be held on the Urbana–Champaign campus during September 7–9, 2000. The symposium will be funded by the KPMG LLP Foundation. Authors of papers employing rigorous research methods (including exploratory methods when appropriate) are invited to submit papers. The scope of the symposium is broad, encompassing all aspects of auditing in all of its phases.

The Office of Accounting Research of the University of Illinois will publish a synopsis of each paper presented and discussants' remarks as a monograph. The intent is that such publication will not preclude authors from submitting completed papers to scholarly journals. Authors should follow *The Accounting Review* format and submit three double-spaced copies of the papers to:

Professor Mark Peecher or Ira Solomon
Fourteenth Symposium on Auditing Research
University of Illinois at Urbana–Champaign
Department of Accountancy
1206 S. Sixth Street
Champaign, IL 61820
isolomon@ux1.cso.uiuc.edu
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A separate cover sheet should contain the name and address of the author to whom correspondence should be addressed. The deadline for submission of completed papers is May 1, 2000. Questions about the symposium should be directed to Mark Peecher or Ira Solomon at the above address.

Presentation by AAA Auditing Section President Karen Pincus to the Panel on Audit Effectiveness, October 8, 1999, New York

Note: This is a summary, not an exact text of the presentation. In addition to the presentation, a packet of additional information was provided to the Panel. A question-and-answer session followed the presentation.

The American Accounting Association is the primary professional organization for accountants in education. The AAA had almost 8,000 members at start of this fiscal year, July 1, 1999, of which about 89 percent are academics. Of the academics, about 5,200 are U.S. academics, the rest are from around the world. I am here today as President of the Auditing Section of the AAA to present the views of AAA members, but I feel a bit like a member of the SEC because I must point out that these are views of members, not an official position statement of the AAA as an organization.

Whose Views Are These?

The views I am presenting come from two sources. First, in the spring of each year, the AAA holds a series of regional meetings which are attended by the current or incoming president. Almost 1,500 professors attended the 1999 Regional Meetings. At the 1999 meetings, the AAA's 1999-2000 president, Jan Williams (University of Tennessee), and 1998-1999 president, Mike Diamond (University of Southern California), held a series of discussions with members about what the greatest challenges facing accounting education are today. This was not a formal survey, but more a "gut check" about what is most on members' minds.

Jan Williams summarized member reactions as "eight challenges facing accounting education," which included competition, resources, students, international, relevance, integration, technology, and skills. All but the first two, which are environmental, relate to questions raised by the Panel about whether we are attracting a sufficient supply of the best and brightest to accounting and a variety of curriculum issues. So, my presentation today is based partly on member views from the general AAA membership related to students and curriculum challenges.

In addition to regions to which everyone belongs, the AAA also has interest area sections. My second source is the Auditing Section, which currently has about 1,700 members. As President of the section, I sent an email request to members asking them to provide their views in three areas: curriculum, recruiting (students), and research. My printed stack of replies is almost nine inches high.

These questions asked members for their own particular perceptions, their own world view. While academics, like everyone else, have our own world views, we also recognize that perceptions and reality may differ. As an example, consider the recent 1999 Business Fraud Survey conducted by the IIA and IOMA, which asked for perceptions or world views.

The internal auditor respondents had very strong perceptions about external auditors and fraud. According to a September 13 press release: 41 percent viewed external auditors as "cavalier" when it comes to fraud detection, failing to accept it as their job, and another third said external auditors are "earnest but inept." So, almost three in four internal auditors have a very negative world view about external auditors and fraud detection. The unanswered question, of course is how closely that perception maps to reality. My caution here is that I will present member perceptions on recruiting and curriculum issues, but acknowledge that our world views as everyone's may be inaccurate.

Before I report on the perceptions questions about curriculum and recruiting, remember that the other area addressed in my email was research because research is the academy's best effort to search for truth, or at least for more accurate perceptions. In addition to recognizing the difference between perceptions and reality, members noted several things for the Panel to consider about research.

Research

Members hope, and expect, that you are reviewing the published research in areas related to your concerns, including those on earnings management, the audit process, audit judgment, fraud, litigation, and education issues. If any additional help is needed, the AAA Sections may be a source of assistance.

In addition, many Auditing Section members have working papers on projects in process. Several sent copies to share with the Panel. Some of these working papers are directly related to issues the Panel has raised. For example, a working paper by Bob Libby (Cornell University) and Bill Kinney (University of Texas at Austin) reports on two experiments with Big 5 audit managers ("Earnings Management, Audit Differences, and Analysts' Forecasts"). Among other things, they found empirical evidence that managers expected their clients *not* to record immaterial adjustments when the adjustments would cause reported earnings below the consensus analyst forecast, which ties very clearly to one of the questions raised by the Panel.

A number of members felt strongly that more research on audit effectiveness is needed. They believe both education and practice could be improved by detailed, objective studies of cases of audit failure—a bit like the morbidity studies done in medical research. They also believe it would be useful to do research on cases of detected frauds, so we can learn more about how to do things right. Yet, given our litigious environment, members are painfully aware that firms cannot afford to make cases available for study and the Public

(Continued on page 24)

Oversight Board cannot even disclose good descriptive data about the cases they review. Several members suggested that the Panel consider whether some regulatory protection might help in this area. One possibility suggested was some form of safe harbor protection for release of data for research after an appropriate passage or time or an appropriate point in litigation. There was a strong call for better access to cases for study, along with the need for some protection to firms providing data.

Curriculum Issues

Now to the perception questions. First: curriculum issues. The challenges identified at the AAA 1999 Regional Meetings included five related to curriculum. They indicate how difficult it is to keep pace with:

- rapid globalization, which affects both business processes and accounting and auditing standards—there is a recognized need to increase coverage of international issues and integrate international topics into accounting courses.
- the need to develop students' skills and competencies, including critical thinking skills, understanding of business processes, and communications skills.
- the growing need to integrate accounting technical knowledge (such as creating a more integrated view of financial reporting and tax, or auditing and management control) and also to integrate accounting and other business knowledge (such as finance and management) many viewed this as the greatest challenge for accounting educators.
- the endless race to keep up with developments in technology, including things like enterprise resource systems that create an almost completely new world for auditors, and data mining software that provides some leverage that could be used to improve audit effectiveness.
- maintaining our own relevance, while there are clear exceptions, many faculty find it a difficult challenge to keep current about business processes, auditing/assurance processes, and technology.

Auditing Section members were asked: What are students being taught in today's auditing courses? How are they being prepared to meet the challenges of the current environment? One source of information for the Panel is the Accounting Coursepage Exchange (ACE) established this year by the American Accounting Association. ACE provides lists of both graduate- and undergraduate-level auditing courses, with links to coursepages that provide details. Both from the ACE examples and other examples reported by Auditing Section members, a few trends are clear: At the graduate level, auditing/assurance courses have been continuously evolving to keep pace with the current environment. For example, just look at the titles of some graduate courses listed on ACE—Auditing in an IT Environment, Assurance and Attestation, Fraud Prevention and Detection, Information System Control and Audit. These courses involve much deeper coverage than traditional courses about business processes, risk assessment, technology and fraud—and a heavy emphasis on critical thinking skills and communications skills.

At the undergraduate level, there are also changes, such as added courses in operational auditing, which help build an understanding of business processes, but the changes are neither as broad nor as deep as at the graduate level. Some members expressed some concerns about auditing/assurance education that might help explain this. In particluar, Auditing Section members perceived at least five weaknesses in current audit/assurance education some of which are auditing specific examples of the challenges noted by the general AAA membership:

- The "squeeze" problem—every year there is more to cover, which means something is always getting squeezed out.
- The need for more "tools" training—e.g., statistical sampling, regression analysis.
- The need for more audit technology training.
- Out-of-date auditing textbooks still in wide use (the lag problem, rather than lead problem—education change is too slow compared to the pace of change in business), and not enough good cases for classroom use.
- The need for faculty to gain/refresh experience, even those with public accounting experience find the half-life of their experience is increasingly shorter before they are out of date.

Recruiting Issues

My email to Auditing Section members asked: What are students' perceptions of auditing as a career? Are we attracting the best and the brightest to the profession? If not, why not?

Out of all the Auditing Section member replies, only a handful expressed any concern at all about the quality of students at their school. In fact, a number had empirical evidence to support their contention that quality was not a problem. By both input measures (such as SAT or GMAT scores) and output measures (such as honors graduates), many schools can prove that accounting's best students are at the very top of our colleges and universities.

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Panel on Audit Effectiveness *(Continued from page 24)*

But, there are a lot of concerns about *quantity*—many schools have experienced declining numbers of accounting majors. Even at schools where enrollments in accounting are not declining, members note enrollments are not increasing fast enough to keep pace with market demands—there *is* an undersupply. As one member noted, "We place all our graduates with major firms. We could place twice as many if we had them."

The chief perceived reason for the undersupply of majors, is that other majors, particularly technology-oriented majors (such as Information Systems) are more appealing to today's students. High tech is *in*, and high tech pays much higher starting salaries than public accounting. Students often choose a major when they are 18 or 19, and those starting salary figures play a huge role. Long-term opportunities and partner compensation are too far away to be a big decision factor. That changes at the graduate level somewhat, but if we lose the sophomores, we may never get the graduate students.

As to the other supply problem, an inadequate supply for recruiters, the #1 reason cited by Auditing Section members was attractiveness of other accounting opportunities, including increasingly attractive internal auditing jobs and industry accounting jobs. Public accounting no longer has a big perceived advantage over industry as a place to start a career. In addition, other employers including the public accounting firms' own consulting arms, pay equal or higher entry level salaries. The traditional salary premium for public accounting is a distant memory.

A third cited reason is a perceived failure of public accounting firms to differentiate between graduates of varying quality—either between or within programs. Ironically, while the larger firms drove more forward-thinking universities to change their curriculum in some of the ways you can see on ACE, the perception is that firms still treat graduates as a "commodity"—they don't pay a significant premium based on quality of program or rank in class within a program. Nor do they differentiate in fast tracking new hires or training new hires. As one member put it: "In effect, we are creating Porsches that some CPA firms can only drive around the block. These offices are locked into the practice of treating every hire the same, regardless of preparation."

Another quantity problem is the seriously dwindling supply of Ph.D. students. This does not bode well for the future—you can't have quality education without quality faculty and our pipeline of recruits is rapidly shrinking.

2000 ABO RESEARCH CONFERENCE
October 6–7, 2000
Chicago, Illinois

The Accounting Behavior and Organizations Section of the American Accounting Association invites you to attend and participate in the 2000 ABO Research Conference. The Conference will be held on Friday and Saturday, October 6–7, 2000 in Chicago, Illinois. Final registration details will be available in future editions of the *ABO Reporter* and *Accounting Education News.*

Call for Papers

Academicians, practitioners, and doctoral students are invited to submit research papers for possible presentation at the meeting. Papers in all areas of behavioral accounting will be considered. Theoretical papers and papers based upon empirical research are appropriate. Diverse methodologies are encouraged, including field, experimental, and critical research. Replications and extensions of previously published studies will be considered. Special consideration will be given to papers that are creative, that address relevant problems, and that possess interdisciplinary insights.

Call for Participants

Persons interested in serving as paper reviewers, paper discussants, or session chairs should send a letter or email with name, eposition and affiliation, complete address, telephone number, email address, and areas of interest to Professor Tim Fogarty, Case Western Reserve University at the address below.

Conference Facilities

The Conference will be held at the Palmer House, a charming "old-world" hotel in the Loop in downtown Chicago. This location will make it easy for everyone to get there. Train transportation to the front door of the hotel is available from both Chicago's airports—O'Hare and Midway. For most attendees, the Chicago location also means reasonably priced and convenient flights. Chicago offers a vast array of entertainment possibilities. A large selection of restaurants is within walking distance. Perhaps the Chicago Cubs or White Sox will be in the World Series! The architecture of the downtown area is itself incredible. The weather should be pleasant. Experienced Chicago people will tutor the novices in the joys of this city.

Guidelines for Submission of Papers

1. Papers should not have been published prior to the conference.
2. Four copies must be submitted. The four copies should not contain any author identification.
3. The cover page should indicate the following information:
   a. Full names of authors.
   b. Position and affiliations.
   c. Complete address.
   d. Telephone and fax numbers.
4. Papers should be prepared according to the reference and footnote guidelines of the American Accounting Association (see *Behavioral Research in Accounting*).
5. Papers accepted for presentation may, at the option of the author, be considered for publication in *Behavioral Research in Accounting* (*BRIA*) or *Advances in Accounting Behavioral Research* (*AABR*). Authors should indicate at the time of conference submission if the paper should also be considered for journal publication. Authors should indicate if they would like the paper to be considered for publication in *BRIA*, *AABR*, or both journals. Papers considered for journal publication will be reviewed in accordance with the review procedures for the selected journal.
6. Papers should be sent to Professor Tim Fogarty, Case Western Reserve University (see below).

(Continued on page 27)

ABO Research Conference *(Continued from page 26)*

Important Dates

May 15, 2000—Final date for submission of papers and notice of participant's interest.

Nonrefundable submission fee for papers is $50, payable to AAA/ABO. First paper's submission fee applies toward registration—see below.

June 30, 2000—Notification of Acceptance of Papers

September 5, 2000—Deadline for conference registration. Early registration fee is $215 ($165 for submitting authors; $65 for doctoral students). At least one author of each accepted paper must register for the conference. A registration form will be mailed to all ABO Section members and will be available on the Section's webpage. Nonmembers interested in a hard-copy registration form should contact one of the conference coordinators.

October 6–7, 2000—Conference Dates

Conference Coordinators

Professor Timothy J. Fogarty
Case Western Reserve University
Department of Accountancy
663 Enterprise Building
Cleveland, OH 44106
Phone: (216) 368-3938
Fax: (216) 368-4776
Email: tjf@po.cwru.edu

Professor Dennis Bline
Bryant College
Accounting Department
1150 Douglas Pike
Smithfield, RI 02917
Phone: (401) 232-6402
Fax: (401) 232-6319
Email: dbline@bryant.edu

Call for Nominations
Outstanding Auditing Dissertation Award

The Auditing Section seeks nominations for its annual Outstanding Auditing Dissertation Award. The author of the dissertation judged to have made the most outstanding contribution to auditing knowledge, among those dissertations nominated for consideration, will receive the award. The assessment of what constitutes an outstanding contribution will be based on, but not limited to, the following criteria:

- the timeliness and importance of the problem(s) addressed;
- the creativity of the research;
- the development of a theoretical framework;
- the appropriateness of the research method and analysis;
- the potential for publication in a scholarly journal; and
- the potential for the results to have an impact on the practice of auditing.

An outstanding dissertation can be expected to rate highly with respect to all of these criteria. Selection of the award winner will be made by the Section's Outstanding Dissertation in Auditing Committee.

A dissertation must be nominated by either the person who authored it or one or more members of the dissertation committee. Nominations will be considered to be complete when the following materials have been submitted:

- A letter from the dissertation chairperson stating that a dissertation has been completed and accepted by the degree-granting institution between January 1, 1998 and December 31, 1999 (dissertations can be nominated more than once);
- Five copies of a nomination letter stating why the dissertation is deserving of special recognition; and
- Five copies of a single paper from the dissertation that meet the criteria for papers submitted to *Auditing: A Journal of Practice & Theory* (refer to the latest issue for requirements related to length and other matters, e.g., submission of questionnaires and experimental instruments).

Please send all materials to:

Professor Stanley F. Biggs
Department of Accounting
School of Business Administration
368 Fairfield Road
University of Connecticut
Storrs, CT 06269-2041

Entries must be received by July 1, 2000. The award recipient will be notified by October 1, 2000, and will receive the award during the Midyear Auditing Section meeting in January 2001.

A REPORT FROM THE EDITOR OF *AUDITING: A JOURNAL OF PRACTICE & THEORY*

Arnie Wright
December 31, 1999

This report describes the manuscript flow, time to review, and decision making for *AJPT* for the first six months I have served as editor, 7/1/99–12/31/99. The column presenting information for 1998 is provided for comparative purposes. Fall 2000 will be my first issue.

Manuscript Flow

	1/1/98 – 12/31/98	7/1/99 – 12/31/99
Submissions		
New	66	49*
Resubmissions	35	39
Available for Decision	101	88
Decisions Made	63	69*
Out for Review or Awaiting Decision	38	19
Acceptance Rates		
Accepted for Publication	20	11*
Returned for Revision	13	16
Rejected	30	42*

Reviewing Times

	Mean/Median/StdDev			Mean/Median/StdDev		
Number of days for reviewers to respond	57	50	30	39	32	30

* These numbers include the manuscripts that were submitted for the Waterloo Conference, which was held November 4–6, 1999 at Waterloo. Out of the 20 submissions 5 were accepted and 15 rejected.

American Accounting Association—Auditing Section
Statement of Cash Receipts, Disbursements, and Cash Balance (Note 1)
Twelve Months Ended August 31, 1999

	FY 99 9/1/98–8/31/99 (ACTUAL)	FY 98 9/1/97–8/31/98 (ACTUAL)
Receipts:		
Membership Dues (Note 2)	$22,365.50	$24,236.50
Journal Subscriptions	13,720.00	13,450.00
Sales of Publications/Royalties (Note 3)	2,582.79	12,497.43
Journal Submission Fees	4,850.00	2,825.00
CPE (net)	907.86	770.77
Reimbursements (Note 4)	30,121.20	21,222.42
Midyear Meeting Registration	20,890.00	17,410.00
Miscellaneous Receipts (Note 5)	3,076.74	–
TOTAL RECEIPTS	$98,514.09	$92,412.12
Disbursements:		
Awards	$ 304.95	$ 711.55
A:AJPT — Printing / Distribution (Note 6)	34,466.83	24,416.75
A:AJPT — Editorial Support (Note 7)	20,000.00	15,000.00
Newsletter: The Auditor's Report (Note 8)	8,853.87	3,042.03
Midyear Meeting	37,883.34	29,193.10
Meeting Rooms—Annual Meeting	1,067.52	964.96
Committee Travel	1,160.66	674.29
Miscellaneous Expenses	1,628.11	1,539.71
TOTAL DISBURSEMENTS	$105,365.28	$75,542.39
Cash Increase (Decrease)	$ (6,851.19)	$16,869.73
Beginning Cash Balance	69,073.28	52,203.55
Ending Cash Balance	62,222.09	69,073.28

Notes:

1. The Statement of Cash Receipts, Disbursements, and Cash Balance was compiled from the monthly financial reports received from the American Accounting Association national office.
2. As of August 31, 1999, there were 1,199 U.S. members and 429 foreign members; 1,506 were full members and 122 were associate members. As of August 31, 1998, there were 1,269 U.S. members and 423 foreign members; 1,544 were full members and 148 were associate members. Note, however, that by November 1999 there was an increase to 1,569 full members and 128 associate members.
3. The decrease from the prior year was due to the fact that no large payments were received from the Copyright Clearance Center. Such payments appear to occur once every other year, without definite certainty. The Sales of Publications/Royalties are generally consistent with the amount received during the FYE 8/31/97.
4. The reimbursement represents a reimbursement to the Section from the University of Waterloo for the costs associated with publishing the 1998 Supplement of *A:JPT*. The Midyear Meeting ran a deficit of $17,566. The KPMG Foundation reimbursed the Section $17,566.89 in July 1999.
5. Reflects the new allocation of interest income from the AAA headquarters to the Section, effective 1999.
6. The following issues of *A:JPT* were published during the 98-99 fiscal year: Fall 98; Spring 99; Supplement 1998. Three issues were published (paid for) in the prior year. Increase partly due to an approximate increase of $6,500 for administrative support from Sarasota.
7. Reflects the increased supplement to the university of the *A:JPT* editor, as approved in 1999.
8. Increase reflects charges allocated to the Section for three printed issues of *The Auditor's Report* during the fiscal year ended August 1999 relative to charges for one printed issue during the fiscal year ended August 1998 (other issues in 1998 were electronically disseminated). In addition, Sarasota charged the Section approximately $1,000 for support as compared with nothing in the prior year.

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American Accounting Association—Auditing Section
Statement of Cash Receipts, Disbursements, and Cash Balance (Note 1)
Three Months Ended November 30, 1999

	FY 00 9/1/99–11/30/99 (ACTUAL)	FY 99 9/1/98–11/30/98 (ACTUAL)
Receipts:		
Membership Dues (Note 2)	$ 5,491.00	$ 5,807.00
Journal Subscriptions	6,625.00	6,822.50
Sales of Publications/Royalties	212.19	212.20
Journal Submission Fees	400.00	1,500.00
CPE (net)	120.00	–
Reimbursements	–	50.00
Midyear Meeting Registration (Note 3)	2,870.00	110.00
Miscellaneous Receipts	484.60	558.83
TOTAL RECEIPTS	$16,202.79	$15,060.53
Disbursements:		
Awards	$ 101.65	–
A:AJPT – Printing / Distribution (Note 4)	4,590.00	$ 3,123.00
A:AJPT – Editorial Support	–	–
Newsletter: The Auditor's Report (Note 5)	787.21	2,501.66
Midyear Meeting	482.88	1,030.44
Meeting Rooms—Annual Meeting	–	–
Committee Travel	–	–
Miscellaneous Expenses	167.10	0.78
TOTAL DISBURSEMENTS	$ 6,128.84	$ 6,655.88
Cash Increase (Decrease)	$10,073.95	$ 8,404.65
Beginning Cash Balance	62,222.09	69,073.28
Ending Cash Balance	72,296.04	77,477.93

Notes:

1. The Statement of Cash Receipts, Disbursements, and Cash Balance was compiled from the monthly financial reports received from the American Accounting Association national office.
2. As of November 30, 1999 (1998) there were 1,569 (1,553) full members and 128 (129) associate members; 1,244 (1,251) were U.S. members and 453 (431) were foreign members.
3. The difference from prior year is attributable to Midyear 2000 registration fees collected earlier this year relative to prior year due primarily to online registrations received prior to November 30, 1999.
4. The expenses for the current (prior year) represent first-quarter charges for AAA staff support related to typesetting the Fall 99 (Fall 98) issues of *A:JPT*. Printing charges will appear on the December 99 (98) statements.
5. Prior Year ACTUAL amounts represent printing costs for the Fall 98 issue of *The Auditor's Report*. Printing costs for the Fall 99 issue of *The Auditor's Report* will appear on the December 99 statement.

American Accounting Association
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