

THE AUDIT OF MANAGEMENT PERFORMANCE

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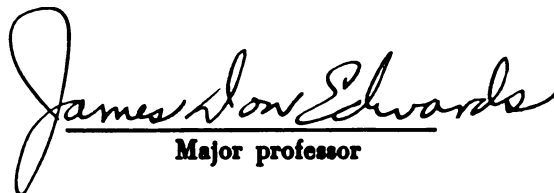
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ABSTRACT

THE AUDIT OF MANAGEMENT PERFORMANCE

by Edwin C. Bomeli

Honesty and prudence are called for in the management of corporate assets which have been provided by common stockholders, who (unlike other contributors of capital) must rely upon control as their security. Lack of effective means of assuring such performance is demonstrated in this thesis, which means that responsibility granted to executives must once again be equated with accountability if government control is to be avoided.

Accountability was accomplished on English manors before 1300 A.D. by having an "auditor" hear stewardship reports, for the purpose of satisfying absentee owners as to the fidelity and honesty with which stewards had handled resources entrusted to them. This concept of accountability was extended to corporations by the British Companies Acts, but in this country these original audit objectives were modified, and American CPA's render an opinion primarily on the propriety of financial statements, despite SEC attempts of the 1930's to stress accountability of management to owners.

Management theory specialists have suggested a management audit, which presumably measures the effectiveness and

efficiency of management. The management audit cannot accomplish what is claimed for it, however, because there is difficulty inherent in the measurement process itself in connection with the development of standards, which must reflect fluid organizational goals. No standard can ever determine how really effective performance is--it can only measure its conformity to the arbitrary standard. Furthermore the unstructured, creative duties of the modern executive are so vast and ill-defined that they do not lend themselves to measurement which is precise enough to render an opinion as to the effectiveness of management performance. It will be impossible (at least within the foreseeable future) to render an opinion upon the effectiveness of management, except in general terms as indicated by the financial results of overall operations.

Accountability, however, does not depend so much upon the actual effectiveness of management performance, as upon the full disclosure of the honesty and sincerity with which management has attempted to discharge its fiduciary responsibilities.

Current applications of extended audit procedures suggest means by which accountability can be assured. The operations audit of industrial auditors is indicative of the feasibility of extending audit techniques to include (at the very least) internal controls of nonfinancial functions, and perhaps even actual appraisal of the function itself. The

policy audits of the GAO calmly and clearly describe how faithfully financial responsibilities of agencies have been discharged. Scandinavian Authorized Public Accountants meet the statutory requirement of commenting upon the fidelity with which the fiduciary relationship between management and shareholders has been maintained.

The following audit modifications would provide a sufficient measure of accountability of management to the common stockholders, whose only security is their right to participate in the management of the corporation:

1. Changing the emphasis of audit procedures to include all quantitative data and to be more interpretive and forward looking in their scope.
2. Placing a far greater reliance upon full disclosure, involving greater use of a Long-Form statement together with a complete description of what has been done and the basis for any conclusions reached.
3. Recognizing the desirability of combining management services and auditing in somewhat the same way it is done in Scandinavian countries, including a recommendation in the auditor's opinion (accompanying management's financial statements) to the effect that management should be discharged of its liability (which in effect attests to its integrity and sincerity).
4. Analyzing profit sources in terms of tentative assignment of responsibility for the operating results, rather than a flat statement of the amount of income.

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CHAPTER I

INTRODUCTION

Corporate management represents (or at least is supposed to represent) owners who are not themselves active in managing, and it is this separation of ownership from control which renders accountability of management to stockholders difficult. The independent financial audit was imposed in 1935 on listed corporations when the SEC was established in an attempt to assist in making corporate management responsible to its investors. Management must in part account, also, to current or potential additional investors every time it is unable to finance expansion through internally generated funds and must rely on the capital market. Neither type of accountability may, however, be very effective.

I. THE PROBLEM

The role of the corporation in modern society and the nature of the relationship between owner and manager are not at all clear at the present time. It is conceivable that the corporate executive is not solely responsible to the investors who put up the money, but is principally a referee who considers the claims and interests of the customer, the community, the employee, and the supplier as well

as the investor. It will be the contention of this paper that although the actions of corporate management must be controlled to a greater extent than the ordinary citizen who is not in a position to wield such responsibility or power (because the consequences of corporate actions are potentially more serious) corporate responsibility is still principally to the investor. It will be asserted that the relationship which exists between investors and management is of a fiduciary nature, and that management is obligated to perform honestly and "prudently" in managing the assets which have been entrusted to it by the owners.

Accountability would be facilitated if an independent appraisal could periodically indicate to the stockholder how well the management is "managing." Proponents of the "management audit" would insist that, given standards to measure performance, and professionally prepared operators, it is possible for an independent appraisal of the functioning of management to be rendered. At the present time management audits, in fact, are being prepared by The American Institute of Management, as well as by others. Since the CPA firm is already familiar with personnel and with the financial and operating data of a client, and particularly since the major CPA firms have expanded their staffs to include engineers, psychologists and mathematicians in order to provide "management services," it might seem that the CPA firm could well include in its audit report an appraisal of management performance.

Actually there is difficulty inherent in the measuring process itself. Since no measurement can determine whether performance is optimal, but only whether results are up to the standard or objectives of the organization, the goals of the organization would need to be reflected in establishing standards of top management performance, and the relative importance of these organizational goals do not remain the same.

Students of management have been able to accomplish a great deal since the First World War in defining the art of management, and identifying the factors that contribute to successful management. The wealth of material that has been published on the subject, however, indicates that although the attributes which are characteristic of successful executives can be classified, the broad requirements and challenges of executive positions make it difficult to prepare a "job classification" for a top executive, and hence to measure his overall performance effectiveness.

The conclusion reached in this paper is that despite the apparent attractiveness of the management audit as a device for securing the accountability of management, our present knowledge is too incomplete and the development of standards too nebulous really to measure management effectiveness.

Some accountants, however, are presently extending audit procedures to include many elements of a "management

audit." Within the profession of internal auditing, the concept of the performance audit has developed to the point where internal auditors attempt to measure how adequately performance of given segments of an operation is conforming to some predetermined standard. The United States General Accounting Office has made considerable progress in revolutionizing the audit approach to governmental units and activities. Assertions, however, by GAO personnel that they are years ahead of the profession are based on the assumption that these techniques could be applied on a total firm basis to render an audit which would make management accountable to stockholders in the same way that governmental divisions are accountable to the Congress. This assumption seems dubious. In Finland and Sweden an interesting provision is written into their Companies Act. The auditor is retained upon a continuing basis, and works with management all during the year. At the end of the year he must include in his audit report an opinion that management should be "discharged from its responsibilities," which means that in the auditor's opinion management has acted prudently and honestly in behalf of the stockholder.

Can the present financial audit actually be modified in such manner as to facilitate accountability of management to investors? It has indeed been greatly modified in the past. The "auditor" initially "heard" the report of the steward of the manor in order to ascertain the effectiveness

of manorial operations, and thus to hold the steward accountable. This concept of accountability was first embodied in the British Companies Act of 1844. It was recognized that separation of ownership and management requires provision of a means whereby management can be held accountable to the investors. In the United States the influence of the British Companies Act was not quite as pronounced, and at first audits were made primarily for credit granting purposes. After the stock market crash of the late 1920's, however, it was felt that some measure of protection was necessary for the stockholder, and that the auditor should be in a position to render that protection; thus the SEC provisions of the 1930's, requiring audits of listed corporations by independent CPA firms.

On the other hand, some developments have actually served to restrict audit scope. Individual client firms have grown to the point where testing became necessary in audit procedures, and the concept of the audit sample developed. It is now recognized also that the audit can not be expected to disclose irregularity. More recently the widespread use of electronic data processing equipment has tended to jeopardize the traditional audit trail, and audit procedure has more and more emphasized determination of the reliability of internal control. Perhaps also the gradual upgrading of the quality of office personnel by client firms has had an effect.

Beyond the scope of the audit, and performed by differently qualified personnel, "management services" are now extensively provided by the major CPA firms. However, although they facilitate the work of management, and stockholders benefit from improved management techniques, they do not assist at all in making management any more accountable to the owners.

II. ORGANIZATION

The purpose of this paper will be to show that audit procedures can be modified so that the audit report prepared by Certified Public Accountants can serve to hold management more accountable without the risk of third party liability which would almost certainly be involved in a true management audit.

Chapter II will provide an analysis of the nature of the corporation, the need for accountability of management, and the present lack of accountability.

Chapter III will be concerned with a consideration of measurement techniques, a definition of management responsibilities, and a consideration of the difficulties in application of measurement techniques to management activities.

An analysis of "management audits" actually being made at the present time by internal auditors, GAO accountants, and Scandinavian accountants will be given in Chapter IV.

In Chapter V the changing scope of audit activity will be examined in the light of historical development, and in

the light of changing circumstances regarding industrial firms in this country. The development of management services activities by public accounting firms will also be considered. The chapter will conclude with a program of audit modifications which would serve to assure honest management discharge of its fiduciary obligations, and render management accountable.

The summary and conclusions will appear in Chapter VI.

CHAPTER II

CORPORATE ACCOUNTABILITY

I. THE NATURE OF THE CORPORATION

The corporation exists within a legal framework, and operates with political sufferance, but agreement has not yet been reached as to its philosophical or theoretical framework.

It could be considered to be essentially any one of the following:

1. An association of common shareholders who own the corporate assets and are liable for the corporate debts. Capital contributed by long-term creditors is recognized as different in nature from the residual type of capital contributed by the common stockholders. Contributions of the latter can be jointly administered with certain legal limitations, but with certain legal privileges, as well. This is sometimes called the proprietary theory.

2. A distinct, separate legal entity responsible to all long-term equityholders. In this case, the corporate assets are represented as belonging to the entity itself, and equity contributions are considered as being not essentially different, i.e. that stockholders are not importantly different from bondholders, for example. The many varieties

of equity instruments, with their gradations as to risks, claims and privileges lend credence to this view. This viewpoint could be labeled the entity theory.

3. A social institution responsible to the public in general. Economic growth and development in the interest of society presumably would be the goal of such an organization.

4. Still another approach, espoused by William J. Vatter, is based upon the accounting recognition (in connection with governmental units) of groups of assets as being identified with a set of activities or functions. Because of this it is sometimes called "the fund theory." This is essentially an extension of the entity theory, which recognizes that in publicly-held corporations it is unrealistic to distinguish arbitrarily between "debts" and "net worth." The entity concept of "claims against assets" would be modified by Vatter to become restrictions against assets, the restrictions being legal, equitable, financial, or even managerial in nature. Since even "liabilities" are not legal debts until maturity, and the owners' "claims" cannot be enforced, this view of equities as "restrictions" has a great deal of validity.

Corporate debt instruments of all kinds are protected with legal safeguards to assure payment if possible--and if not, to guarantee fair, open treatment at least. The safeguard for the shareholder (particularly the common

shareholder) lies presumably in his control of the business. In a large corporation, this control must be exercised through agents, and these agents (management) then report back to their principal for approval. In other words, they are to be held accountable for their acts of stewardship by the owners who ultimately control corporate activity as security for their investment.

Owner domination of business firms, however, particularly in the United States, has declined since the Great Depression, and the ultimate control tends to fall on key employees (executives) of the corporation who, although theoretically responsible to the board of directors, may in fact dominate the board.

The corporation is rapidly becoming (if it has not already become) the dominant form of business organization, and its very nature may perhaps have doomed owner management from the beginning because the needs which give rise to the corporate form serve to restrict the normal ownership control of property. Frequently the corporation is formed because the objects pursued are beyond the reach of individuals. For example, often the intended duration of a project exceeds the anticipated lifetime of any of the entrepreneurs. Also, when a great amount of capital is needed, many sources are necessarily involved, for even if one individual were able to provide such an accumulation, the risks would be too great to be borne alone. Thus the very considerations that

encourage corporate organization doom the contributor to a role which is somewhat different from that of the owner-manager. As a matter of fact, despite the lingering fiction of democratic government by shareholders, indications are that government by corporate membership was already losing reality as early as the seventeenth century.¹

Of course, the large corporation is vastly different in other ways as well from the small family owned concern. Oswald Knauth² has attempted to designate these differences between what he calls "free" enterprise and what he calls "managerial" enterprise. Capital in the "free" enterprise tends to be fluid rather than sunk as in the case of the large corporation because although the individual owner applies or withdraws investment funds as actually needed, the corporate manager conceivably tends to retain available funds because they might be needed, and in fact to seek for a place where they could be used in order to expand the area of his own influence. Then, too, investment or withdrawal of corporate capital is difficult because of restrictive legal provisions.

¹Edward S. Mason, The Corporation in Modern Society (Cambridge, Mass.: Harvard University Press, 1960), p. 34.

²Oswald Knauth, Managerial Enterprise: Its Growth and Methods of Operation (New York: W. W. Norton and Company, Inc., 1948), p. 33.

The small business is more flexible than the publicly owned corporation, which is characterized by standardization and relative rigidity. The concentration of wealth and power also makes the policy and program of each huge corporation unit of political and national significance, although the individual entrepreneur may not much effect the national scheme. The individual operator must adjust to market conditions which are impersonal to him; the "managerial" enterprise finds that market conditions at the very least respond to its policies, and possibly are even shaped by them.

Response to changes in demand is different, too. Increased demand tends to drive price down for the atomistic operator as other firms rush in to compete; increased demand merely results in an increase in production for the "managerial" enterprise. On the other hand, costs can be estimated accurately for the "free" enterprise, but must be based instead upon actuarial assumptions by the "managerial" enterprise. Attitudes toward business goals, too, tend to be different, and the unincorporated enterprise has to be concerned with immediate profits, while the "managerial" enterprise enjoys, on the other hand, the luxury of striving for the attainment of a stable and adjusted system, the smooth functioning of which creates profits. To be sure, it is partly the difficulty of explaining and justifying such goals that makes the large corporation vulnerable to stockholder criticism.

Corporations though, like the rich, get richer, and within the past century an enormous concentration of corporate wealth has occurred. In 1959, the 500 largest firms in this country provided 50 per cent of the sales of all manufacturing and mining operations and 70 per cent of the profits.³ Since diffusion of ownership is desired by corporate management upon such grounds as public relations, customer relations, and probably freedom from interference by owners, it may well be that corporate management is what Kolko⁴ calls the "single most important group" in America in terms of power. He estimates that 43 per cent of the total assets of nearly half a million corporations are controlled by the 200 largest non-financial corporations in this country, which in turn are controlled by less than 2,500 men. Without a question an enormous concentration of economic power has occurred, whether or not these particular estimates can be validated.

II. THE CORPORATION AND THE LAW

Early corporations by an accident of history actually became extensions of governmental authority. Merchants faced an opportunity which was not only beyond the reach of

³"Have Corporations a Higher Duty than Profits?" Fortune, Vol. 62 (August, 1960), p. 108.

⁴Gabriel Kolko, Wealth and Power in America (New York, N. Y.: Frederick A. Praeger, 1962), pp. 56-57.

individuals, but was in fact beyond the reach of nations themselves. Their call was to a field of endeavor that transcended the bounds of the realm, and since a government could not assert its sovereignty beyond its own borders, early English companies, for example, "with delegated authority . . . carried the Government of England wherever they went."⁵ As a matter of fact, the English East India Company was endowed with the power to make war or peace.

Although corporations were not provided for in the Constitution of the United States, as early as 1791 the Federal Government found that it would be desirable to organize a corporation (The Bank of the United States) and in 1819 in the famous McCullough vs. Maryland case it was held that the implied powers of the Federal Government allowed the formation of a corporation for government or quasi-government purposes.

The right to create business corporations, though, was reserved to the states, and was viewed gravely indeed by them. Severe limitations were observed to keep these corporations from getting out of line. They generally could own only a limited amount of property, and limitations were especially strict regarding real estate, for the states did not want to risk having themselves literally bought up. Corporations could indulge in only one type of business.

⁵Walton H. Hamilton, The Politics of Industry (New York, N. Y.: Knopf, 1957), pp. 65-66.

They were ordinarily established only for a limited period of time, and were even sometimes subject to continuous inspection by the courts. The right was reserved in some instances to the courts to appoint what was called a "visitor," who was authorized to inspect and analyze the workings of a corporation and report to the judge, a sort of "audit." (It was in fact what would now be called an "operational audit.") These artificial beings, however, could never be held in line and were constantly caught trying to exceed the limits of activity spelled out in their state charters. In fact ultra vires acts engaged the primary attention of corporation lawyers and the courts for the most part up until about 1885, which would seem very strange in comparison with today's liberal and diversified corporate activity.

Since the separate states charter corporations it is natural that requirements vary in the several states, although at least two attempts have been made to establish uniformity. In 1928 a Uniform Business Corporation Act was approved by the Commission on Uniform State Laws. This uniform act (or a substantial version of it) has only been adopted in four states: Louisiana, 1928, Idaho, 1932, Washington, 1933, and Kentucky, 1946.

It is interesting to contrast this 1928 effort with the 1951 Model Business Corporation Act which is being promoted by the Committee on Corporate Laws of the American Bar Association. Seven states have adopted this latter version:

Wisconsin, 1951; Oregon, 1953; District of Columbia, 1954; Texas, 1954; Virginia, 1956; North Dakota, 1957; and Colorado, 1958. The effect of the later act would in the opinion of Emerson⁶ substantially restrict the rights of shareholders to participate democratically in corporate affairs. The newer act abridges inspection rights of stockholders at meetings, limits availability of the voting list to 10 days (which is obviously much too short for the organization of a proxy fight), reduces the possibility of election of minority board members (thus obtaining a voice in selection of officers) by making cumulative voting only optional instead of mandatory as it was in the 1928 Uniform Act, and is vague and inadequate with respect to requirements as to furnishing financial information. Further, some fairly fundamental rights are impaired, e.g. the right to amend by-laws, and rights with respect to management-initiated "fundamental changes" such as the lease or sale of corporate assets.

In addition to the recommended restrictions in the so-called Model Act of recent vintage, other legal developments have further served to restrict stockholder power. Statutes as well as judge-made law treat "professional" stockholders' suits unfavorably even against managements which are accused of misusing money, for the right of suit against corporate wrongdoing is denied if it can be shown that the stock was

⁶Frank D. Emerson, "The Roles of Management and Shareholders in Corporate Government," Law and Contemporary Problems, Vol. 23 (Spring, 1958), pp. 231-232.

acquired for the purpose of pressing suit. Thus it is clear that society, at least insofar as its wishes are interpreted by the courts, takes a dim view in general of what formerly was considered appropriate reaction to a breach of employer stewardship of assets. It may be that just as the feudal lord remained the theoretical owner long after the tenure had become a freehold, stockholders may now hold title to property, the effective ownership of which has passed to some one else.

Since the courts have thus made it difficult for stockholders to act against management a question of corporate accountability inevitably arises. Just exactly to whom is a corporation and its management accountable? The general legal principle stated by Fletcher in 1931 apparently still holds.⁷

Directors and other officers, while not trustees in the technical sense in which that term is used, occupy a fiduciary relationship to the corporation and to the stockholders as a body. . . . But whether or not directors and other corporate officers are strictly trustees, there can be not doubt that their character is that of a fiduciary so far as the corporation and the stockholders as a body are concerned. In other words, it is unquestionably true that, as agents entrusted with the management of the corporation, for the benefit of the stockholders collectively, they occupy a fiduciary relation, and in this sense the relation is one of trust.

In other words, from a strictly legal point of view, the management (and hence the corporation itself) is related in

⁷William Meade Fletcher, Cyclopedia of the Law of Private Corporations (Chicago: Callaghan and Co., 1931), Vol. III, Sec. 838.

a fiduciary capacity to the stockholders whose property they manage.

This would mean that: (1) the highest fidelity to the interest of the corporation is exercised by management, and (2) management duties are discharged with reasonable care and reasonable prudence.

Exercise of the highest fidelity would mean dealing fairly and honestly, in good faith, that no personal gain would be enjoyed by management disproportionate to its actual investment, and that any personal gain arising from dealings where a conflict of interest might exist would be accounted for.

The discharge of duties with reasonable care and reasonable prudence seems to mean the exercise of such diligent care and skill as ordinarily prudent men would exercise under similar circumstances in like positions.

Apparently, then, although stockholders find their explicit rights dwindling, the courts increasingly incline toward considering there to be a fiduciary relationship existing between the stockholders who own but do not control, and the management which controls but owns little.

III. STOCKHOLDER STATUS

In addition to defining the fiduciary relationship, the courts have assured stockholders of certain rights, whether or not stockholders choose to exercise them, or

even care about having them. Owners are interested in many things but many of them may not be very much concerned about the measure of control they possess so long as earnings and dividends are as expected. Despite their own lack of interest and inertia the courts have moved to safeguard their rights.

The stockholders do have the right to elect new directors, if they do not approve of the old ones. It is true that this privilege may prove to be a costly one, and require stout hearts as well as ample purses. To amass sufficient support to remove directors is quite a job, and a newsworthy one at that, as for example the Sewell Avery--Louis Wolfson fight over Montgomery Ward, and the New York Central proxy fight. The Montgomery Ward proxy contest proved, also, that even a well-organized and well-financed effort does not necessarily accomplish its goal, for Avery's faction won, at least on the surface, although subsequent changes did accomplish substantially what the "losers" had sought. The threat, therefore, of removal of directors remains despite the cost and effort entailed in its accomplishment.

Certain acts of the officers and directors also form the basis for legal action against them. Misuse of powers, gross mismanagement, fraud or dishonesty represent a breach of the fiduciary relationship, and management can be held accountable for them. Note that it is not really necessary for management to provide good management; it would actually

probably need to be really bad before it would be anything like gross mismanagement. But it is supposed to be honest management, and that much at least the stockholders can expect as their right.

Perhaps the most important right, at least in terms of the number of times it is exercised, is the right to sell. This indeed is not an unimportant right, for the availability of a quick buyer at a nationally quoted price has real value. It should be pointed out that so long as the market for any given shares of stock is protected, the actual importance of control may not be so very great. There are a great many people who have control of their property (such as for example real estate limited to a specialized use or stock in a close corporation) who would be quite willing to sacrifice some of their control in return for ready marketability. Perhaps it is indeed appropriate that as diffusion of ownership occurs, diminution of control also occurs, and marketability increases. On the other hand, the specter of sudden catastrophic disappearance of marketability due to poor management tends to make this right less appealing, for it is always possible that just when a disillusioned owner wishes to sell, everyone else will want to sell at the same time. Still it is a right, and the right "to be included out" is important.

Shareholders seem to possess certain other rights either by law or by custom supported by the courts. They seemingly have the right to know the purpose of all major

disbursements, and the salaries of all officers. Stockholders can examine stockholder lists for a period of ten days before the annual meeting, and have the right to peruse the minutes of the previous meeting. They are also entitled to details as to corporate assets.

Perhaps the importance of the actual votes of stockholders has been over-emphasized all along. At least, Berle in a recent book⁸ asserts that the public opinion generated by stockholders has always been a much more effective curb on management than the accumulation of the actual votes. Apparently, though he is still as cynical about the effectiveness of any curbs as he was when he wrote his monumental work about the corporation in 1933. His contention at that time was that stockholders did not and could not effectively exercise any restraint or control over management, that management could rely on internal financing (this was during the depression years) and would never need to go on the market for new funds, and that public control of large corporations was necessary to insure their social responsibility.⁹

Concurrent with the increasing diffusion of stock ownership that finds hundreds of thousands of little investors owning a few shares of stock, a counter trend has appeared

⁸A. A. Berle, Jr., Power Without Property (New York: Harcourt, Brace and Company, 1959), p. 53.

⁹A. A. Berle and G. C. Means, The Modern Corporation and Private Property (New York: Macmillan, 1933), p. 277.

within the last few years: the accumulation of portfolios by institutional investors. Of particular interest is the increasingly common pension trust arrangement which provides employees upon retirement with continued income based upon their earnings during employment by the firm. Since these pension trusts need to provide for obligations that cannot yet be determined and which are subject to future changes in dollars, prices, and pay which are unknown, their investment problem is far different from that of insurance companies, for example, who face fixed contracts. The pension trusts, then, obviously must invest heavily in equities. Berle gives some interesting data concerning the magnitude of these pension trusts and their probable impact upon corporate accountability.¹⁰ Although insurance companies may have in the neighborhood of five per cent of their assets invested in equities, pension trusts may well have over 30 per cent of their assets so invested. By 1957 the pension trust funds had reached the staggering total of \$31 billions, and Berle estimated that it would be 30 years before the payments out of these funds would equal on the average the additions to the funds, and they would by that time level off at \$80 billions (increased by the coefficient of the increased labor force). Currently, he estimates that roughly half of

¹⁰A. A. Berle, Jr., Economic Power and the Free Society (Santa Barbara, California: The Fund for the Republic, 1957), pp. 10-12.

these funds are in the hands of insurance companies, and that perhaps another 45 per cent are in the hands of 8 or 9 New York banks. An interesting variant from the usual pension fund arrangement of investment in a diversified portfolio is the case of the pension trust of Sears, Roebuck and Co., where investment has been made in securities of the company itself, and presumably the company is controlled by the trustees of the pension fund in behalf of its own employees. In the case of pension fund control in the hands of the company directors we find an interesting problem of accountability: are the directors accountable to themselves acting as trustees for the pension fund?

The problem of corporate accountability may be aggravated by the fact that soon, if not already, the real power nucleus may well lie in the hands of the trustees of these pension trusts, rather than in corporate management. To be sure, these trustees have not to date chosen to use their power. They seemingly consider their interest to be purely financial. Not being owners, they do not care to be managers, either. They feel that as trustees they can only act as trustees and that any interference with management is beyond the trust they have received. Consequently they either vote with management or sell the stock.

It is possible that they may never wish to use their power for the same reasons that they now refrain from using it. They may be inclined to feel that they should never have

bought shares in a company if they do not have confidence in the management and may feel that their duty lies in continued loyalty to the company. Perhaps they too can afford to take the long view. Perhaps they do not feel that they have either the time or the competence to assert any management force in the variety of companies owned. This perhaps may not be unrelated to a precautionary recognition of the possibility of tragic or unsuccessful participation for which they might be blamed. They undoubtedly feel the same uneasiness about professional stockholders' suits previously mentioned, and fear that a vote against management may open the way for "raiders" to gain control.

Their contention that they can always sell the stock as a protest against management, however, could conceivably cause serious repercussions. Who is going to buy the quantity they are going to sell? And what if two or more (or several) decide to sell the same securities at the same time?

Moreover there are even more serious implications possible. Actually the clients of the trustees are being disenfranchised without any consultation, and it would be more socially desirable to try to improve share value rather than merely to dump the securities summarily, for the small stockholders then lose and are unable to do anything about it. Public authority may well be invoked to fill the vacuum if these institutional investors continue to grow, and continue to vote with management as a matter of course.

As Kolko points out, however,¹¹ the contention that management controls but does not own may not be strictly true any longer, since the advent of the executive stock option. This device has developed so rapidly during the decade of the 1950's that it might almost be characterized as the era of the stock option. Since, without profits, these options to buy stock at a favorable price do not have much value, presumably their issuance to executives should commit top management very strongly to a strong profit position. By 1957, 77 per cent of the manufacturing corporations listed on the two major New York stock exchanges had instituted option plans; and of the top 100 industrials, published data for 83 of the 87 who had option plans revealed that on the average 1.9 per cent of their outstanding voting stock had been optioned to key officers. By 1960 Inland Steel had assigned the equivalent of 11 per cent of its outstanding voting stock for executive options, and Ford had reserved 6.7 per cent of its outstanding shares for future options.

Management ownership of securities does not, however, assure accountability to other stockholders. In the first place, ownership of a substantial block of stock is not an effective guarantee of honest trusteeship for the rest of the owners. Given a choice between an immediate personal gain (which might work of the detriment of the whole body

¹¹Kolko, Op. Cit., p. 66.

of shareholders) and a corporate advantage (some of which would eventually accrue to an officer's personal gain) many officers would be tempted to take care of themselves first. It is not necessary to suggest that officers are dishonest; it is only necessary to point out that ownership of a substantial stock interest would not deter the seeking of personal advantage (for those with such inclinations) over corporate advantage, only a portion of which would accrue personally.

Secondly, there is a far more serious logical defect in this whole approach. It would seem that the erosion of stockholder status is recognized, and yet it is desired to maintain carefully, in actuality as well as theory, the trustee status of management in relation to stockholders. Therefore management is permitted to share in the ownership with the stockholders, so they will have the "owner" outlook. This is, of course, a peculiar kind of "restraint." Can it be that, in order to keep management honest, they must be given the corporation?

There is, of course, always the possibility that small individual owners need to be protected from themselves. Just as was pointed out previously when describing Knauth's analysis of the difference between the "free" and the "managerial" enterprise, the unincorporated enterprise may have to consider the short-run rather than the long-run point of view. In like manner the individual owner of relatively few

shares may generally incline toward the short-run point of view. This is frequently not in the best interests of himself, the corporation, or society as a whole. So perhaps the strange situation exists that in order to preserve the precarious status of the shareholder, his trustee must be freed of possible interference by the property owner, who, like the lemming, would destroy himself.

That this might be true, however, does not in any way lessen the desirability of corporate accountability, nor alter the fiduciary relationship of management and shareholders, or the necessity of reasonable restraints to curb excesses or malfeasance.

IV. THE CORPORATION IN SOCIETY

It is interesting to speculate whether a case can be made for a legal analogy between the political state and the corporation, and whether there exists a workable system of checks and balances that can be depended upon to protect the rights of the parties at interest in the way our Federal system of checks and balances works. The shareholders in such an analogy, of course, would be the electorate, and their ballots would review the decisions of the management and return it to office if satisfactory. The management becomes the equivalent of the legislative branch, which initiates action and directs its execution. There is no equivalent for the judicial branch as none is needed because all

the regular judicial levels are available to private citizens in dealing with each other or with the various political subdivisions.¹²

Minority stockholders are not informed and they are not organized; as a consequence their "suffrage" may be meaningless. Regulatory groups have tried to make it work anyway. The SEC has busied itself trying to make the votes of stockholders effective for their own protection and has not shown any interest in "social responsibility." Its function is to inform and point out to security holders and potential security holders possible weaknesses in the chain of their protection, and although SEC interest is not limited to common shareholders, the nature of common stockholder risks leads the Commissioners to be more active in behalf of such non-preference shareholders.

Probably, though, the stockholders are not equivalent to the electorate of a political state, and greater shareholder representation cannot necessarily be justified. If financial information is furnished, if corporate well-being takes precedence over personal management advantage, and if a market exists continuously for disposal of securities, stockholder interests are protected. Such a narrow concept of "membership" may well be inadequate, and it is possible that all groups related closely to the corporation or who

¹²Mason, Op. Cit., pp. 38-41.

are in any way subject to its authority should be included. The electorate, then, in such event, embraces many more elements than stockholder interests, and it is not logically defensible to enfranchise them alone.

The concept of management exercising its powers in trust for the benefit of the owners alone is based upon what Berle and Means call the "traditional logic of property."¹³ In their opinion, however, the "traditional logic of profits" could equally well be applied to the modern corporation, but the effect would be quite different indeed. In this case, the shareholders as owners would be entitled only to a fair return on their capital, i.e. they should receive only the wages of capital. The remainder of the profitable results of operations should go to management as an inducement to the most efficient management procedures. In other words, it is conceivable that the corporation should be operated financially for the benefit of the managers who need pay only a fair compensation for the use the funds advanced by the various equity holders.

A third alternative is instead recommended by Berle and Means as more realistic than either of the preceding. They see the community as being in a position to require the modern corporation to serve all society rather than either owners or management.

¹³Berle and Means, Op. Cit., p. 335.

Corporation law, however, obviously does not intend a public enterprise in the alternative sense recommended by Berle and Means, but rather intends it to be a device for the efficient aggregation of private resources. Eells, in fact, differentiates¹⁴ between the traditional corporation as provided by law and what he calls the "metrocorporation," which will be examined shortly. The traditional corporation is dedicated to serving the property interests of company stockholders, and although recognizing social responsibilities which should be pondered by individuals as good citizens, the manager of such a corporation would prefer to avoid corporate social responsibilities.

Many decisions which appear to reflect a sense of social responsibility are in reality simply a recognition that the short-run or immediate must be sacrificed for future advantage, whether it be a "fair" share for owners as dividends, a "fair" share of labor, or maybe even a "fair" share for management, which is being considered. The day of the big, quick profit has disappeared, and persons and resources may not be abused. Profits are viewed in terms of consistent and long-run growth. Current yields may be sacrificed in order to maximize the total mass of profits in the long run.

¹⁴ Richard Eells, The Meaning of Modern Business (New York: Columbia University Press, 1960), p. 90.

It is true that corporate managements have to consider the interests of diverse groups, regardless of the extent and point of their ultimate accountability. Certainly customers, suppliers, and employees all represent increasingly vocal, and hence politically powerful "publics" which the corporation cannot ruthlessly slight. Corporations, whether they intend it or not, whether they like it or not, have become public institutions in that the standard of living, working conditions, and retirement circumstances of the American people are heavily influenced by them. Necessarily, then, these firms find that their wage scales, their selling prices, and their profit margins are all matters of public interest, and because of their public impact are negotiated in public.

Even the consumer takes cognizance of management efficiency, because of what he considers corporate social responsibility toward the community. The consumer, in fact, may tend to hold management responsible for assuring that the corporation will be a good citizen of the community.

There seems to be no question but that moral conflict is one feature of the executive function. Not only does there exist the problem of curbing self-interest for the greater interest of corporate welfare in certain situations, but today's manager is faced as well with a conflict between corporate purposes (at least immediate corporate purposes) and community or political welfare. Moreover these may in

fact be more complex and baffling than the moral and social issues which seem to confront scientists, because the business executive cannot postpone them

until technical objectives of turning out goods and services have been attained. Nor can he make decisions purely in terms of accepted technical criteria; these decisions impinge immediately and variously on the actual lives of other men and so raise questions of authority and consent. Indeed the moral challenge for the manager is much more complex than for the scientist. The latter shares his profound moral disturbance as a common burden with his fellow citizens; but the industrial manager carries a moral burden which he cannot share. It is not only that he must make decisions which may have harmful consequences; he must make decisions the consequences of which he does not fully know.¹⁵

These moral implications of the corporate executive function have given rise to the feeling that the corporation is accountable to more than the shareholders, and is in fact accountable to the whole of society. According to this concept, management is principally a business referee, and since its responsibility does not end with satisfying stockholders, its ultimate responsibility may lie elsewhere. The relative claims of the various corporate contributors make it extremely difficult to umpire such things as earnings distribution, and even to determine the costs of doing business.

This concept describes what Eells has called the "metro-corporation."¹⁶ The rights and the duties of this type of

¹⁵Sylvia Selekman and Benjamin M. Selekman, Power and Morality in a Business Society (New York: McGraw-Hill, 1956), p. 112.

¹⁶Eells, Op. Cit., p. 70.

public corporation as a citizen are emphasized, rather than the rights and duties of the corporation to its shareholders. The relationships to society are more important than the relationship to stockholders. In his view, however, corporation management is not likely to receive power to assume broad social responsibilities beyond what it now has. In this respect the State and Federal authorizations for corporate giving have had some considerable impact already. Since the large, successful corporation has at its disposal huge money resources, and is increasingly appealed to by fund-raising organizations, it is no wonder that corporate management, confronted with an appeal to an alleged moral obligation, is receptive to the idea of "playing God." Certainly the universities have not been niggardly in pressing their claims for largesse, nor lax in pointing out corporate responsibility for maintaining and strengthening educational facilities. Thus, even decisions as to the direction of the flow of cultural adjustments may possibly be sometimes made in the "executive suite."

Eells reviews some of the arguments against this concept of a corporation, and gives credit to the authors of them.¹⁷ He quotes the economist, Friedman, as being of the opinion that the corporation has only one responsibility: to utilize resources in maximizing long-run profits within

¹⁷Ibid., pp. 79-94.

the limits of honest, open competition. Since the corporation is the "instrument of the stockholders who own it," the stockholders should decide whether or not, and to whom, corporate gifts should be made. He feels that such distribution of corporate assets is a violation of the trust relationship.

Eells credits the Kelso-Adler book, The Capitalist Manifesto, as being in agreement with Friedman. Management is the alter-ego of the owner, and nothing else. These authors deplore the "laboristic distribution of wealth" and would make Capitalism "the instrument of private property and completely responsible to private property."

Eells agrees also with Levitt, who is afraid the businessmen will begin to believe their own propaganda about "serving the public." Levitt feels that "business statesmanship" will end up as "the twentieth-century equivalent of the medieval church." He sees this doctrine of social responsibility as leading us to a new feudalism, and considers the "pretensions" of Big Businessmen as preposterous. As far as he is concerned welfare activities are best provided by the government, and to have them assumed by the modern corporation is a perversion and is undesirable because the objectives of society should be better met by persons who are responsible to society.

Friedrich A. Hayek, speaking at a symposium held on the tenth anniversary of the Graduate School of Industrial

Administration of the Carnegie Institute of Technology, has given us a picture of the probable consequences of the extension of this doctrine of "social responsibility."¹⁸ The immediate short-run effect of adopting the social responsibility concept of the publicly held corporation would be a vast extension of the powers of its management into complex and explosive areas. Corporate management would find itself required to make decisions increasingly having cultural, political, and moral overtones. The question of competence so to act might prove embarrassing indeed, for the well-rounded, broadly educated man envisioned in the Gordon-Howell and Pierson reports is not quite that broadly educated. It would certainly seem that the primary competence of the corporate manager would be in the area of efficiency in the use of resources in production, and that such ability is no proof of capacity in the swampland of social responsibility. Perhaps a still more important consequence would be the substitution of a nebulous, vague and indefinable task for what should be a specific and controllable one: the profitable use of capital entrusted to management by stockholders.

Hayek seems to agree with the conclusion of Berle and Means nearly thirty years ago which was previously discussed: that the long-run effect of adoption of the "social responsibility" concept by corporations would inevitably be control

¹⁸Melvin Anshen and George Leland Bach, Management and Corporations, 1985 (New York: McGraw-Hill, 1960), p. 116.

of the corporation by the state, and the establishment of its accountability to political authorities.

Implications other than accountability result from the separation of ownership and control, from this concept of "social responsibility." Grave problems arise concerning the wise use of resources, for the allocation of resources may reflect a management interest which is quite different from what ownership interest might be.¹⁹ In general stockholder interest might be expected to approximate more closely the public interest than would management's. Incompetent and unrestrained management, however, may serve to distort the workings of the price system in the allocation of resources.

In fact, no matter how competent management might be there are some areas in which it would not be qualified to decide; for example, could an unbiased opinion with respect to partial or complete liquidation be expected from management that controls but does not own? Indeed there is no such thing as a corporate conscience, for conscience is one of the human attributes which the state is unable to create in its creature. Only the individual has a conscience. It is equally clear, of course, that assuring stockholders a clear forthright voice in directing corporate management would not guarantee socially desirable behavior. Social

¹⁹⁰. K. Burrell, "The Corporation's Relationship With Its Owner-Stockholders," The Commercial and Financial Chronicle, Vol. 188 (August 14, 1958), p. 603.

irresponsibility seems present in some unions, for example, even though there is no question of illegality or lack of democratic procedures.

There is, in fact, an increasing awareness that just as "No man is an island," in like manner no business, even the smallest, can exist in a vacuum. Just as the innkeeper and the common carrier are recognized as instruments of the general welfare, the interweavings of public elements among the private are to be found in every business. Government intervention is suggestive of bureaucratic restraints to most businessmen, yet they welcome tariff protection, tax write-offs, and depreciation and depletion allowances. Even businessmen who consider themselves rugged individualists and who fear what they call "creeping socialism" are not so rugged as to turn down a plush government contract. And observe what has happened to the prime example of the economist's pure competition: agriculture, now in the throes of public control. In a sense, then, the concept of corporate social responsibility is based upon an unrealistic assumption: that some business firms need no public overview, and that others either because of their size or their organization form do need control.²⁰

Just as a variety of factors have caused the comingling of public and private elements in all business

²⁰Hamilton, Op. Cit., pp. 18-22.

activity, it is not only the deliberate assumption of "social responsibilities" by corporate managements that have served to make the corporation take on more of the attributes of a public institution. So many citizens are perfectly willing to thrust what were traditionally considered private problems directly or indirectly on the nation's huge corporations. Constantly expanded services are expected from the government in areas formerly privately provided, and corporate taxes are expected to finance them. Increasingly community-wide financial campaigns look to the corporations for support. Public and government sympathy is customarily extended toward the union's request for a "few cents" an hour. Sick leave, health insurance, pension provisions, and even social club fees are expected to be absorbed by the corporate employer.

Kenneth Boulding, like many other observers, considers political intervention to be inevitable, but he hopes that ethical considerations will help balance what he calls the "complex of contending institutions."²¹ This will be only partially in response to the feeling of increased concern on the part of corporate managements for their "social responsibility." If anything, this will be precisely because corporate management has no real social responsibility, and can never have one. People tend to confuse the concepts of "public institutions" and "social responsibilities." The

²¹K. E. Boulding, Organizational Revolution (New York: Harper and Brothers, 1953), p. 16.

large publicly held corporations are public institutions because of their size, because of the diffusion of their ownership, and because the effects of their policies are felt by so many families. To adorn them, however, with the ill-fitting mantle of "social responsibility" places upon them a burden which is utterly unrealistic, which management is incompetent to perform, and which is impossible to administer.

Management's responsibility, as management, seems clearly to the author to be to utilize resources profitably, and to account for its actions to the owners. Such things as business ethics, urban deterioration, politics, racial integration, international affairs, cultural development, industry associations, and education are all intrinsically important, but they are the responsibility of all citizens alike.

V. CORPORATE ACCOUNTABILITY TO STOCKHOLDERS

Stockholders would perhaps settle for somewhat less than accountability to society, and would appreciate a measure of accountability to stockholders. At any rate, despite the difficulties of instituting suits, several hundred actually are filed every year by stockholders against management. There are a variety of reasons. Charges of mismanagement, or of excessive executive compensation or too generous stock option plans may give rise to them. Sometimes

there are complaints against "insiders" dealings in a company's stock resulting in personal profits, or against proposed mergers or consolidations. For every suit that is actually filed, however, there must be many instances of stockholder unhappiness which are not acute enough to spawn legal action or which would seemingly be futile in a court of law. Burrell enumerates the main causes of stockholder dissatisfaction:

1. Poor earnings and dividends record relative to the general business level.
2. Management having outside business interests transacting business with them which might conflict with the interests of the main body of stockholders.
3. Where share prices over a significant time period are below the apparent realizable liquidation value, and especially if the price is below the net current asset value per share.
4. Maintenance of any device which is likely to assure management perpetuation, as for example management voting of company stock held in a pension fund.
5. Cases where a small company possesses any assets, processes, patents, etc., has access to raw materials, or has a "tax loss" which might be of value to a large company.²²

"Stockholders' movements," such as those led by the Gilbert brothers and security analysts, support a platform of good management behavior (from the point of view of stockholders) which contains the following planks:

1. All directors elected annually by cumulative voting.
2. Annual meeting of stockholders held in a convenient location.
3. A majority of directors independent of management.
4. Directors to maintain a reasonable ownership interest in the company.

²²Burrell, Op. Cit., p. 603 ff.

5. Election of auditors by stockholders.
6. Orderly conduct of shareholder meetings, no curbing of free speech--post meeting reports when possible.
7. Reasonable executive compensation geared to performance and subject to review by independent directors or stockholders.
8. No waiver of pre-emptive rights.
9. No "side deals" or self dealing between the corporation and management.
10. Full disclosure.
11. Some partial reimbursement from corporate funds of the losing side's costs in a proxy contest where a substantial issue has been presented and the losing side polled a substantial vote.²³

Indeed the argument of some thoughtful commentators is not that the social responsibilities of the corporation have replaced its responsibilities to the shareholders, but that profit incentive and social sensitivity cannot be separated. The shareholders need not abdicate in favor of either society or management.²⁴

It must be remembered, however, that we have defined the relationship between corporation and stockholder as being of a fiduciary nature, and such a relationship never involves exercise of full ownership prerogatives. In fact, W. A. Paton²⁵ saw forty years ago, that the distinction between proprietor and creditor becomes nebulous in a corporation, and in a sense the managerial task is essentially

²³Ibid.

²⁴Eells, Op. Cit., pp. 92-93.

²⁵W. A. Paton, Accounting Theory (New York: Ronald Press Co., 1922), p. 84.

the operation "of a mass of properties in the interest of a whole body of investors of various classes." Of course, however, "the liabilities are in general fixed and contractual. The stockholder's equity is elastic and residual." That being the case, the stockholder may be in a bad way as a claimant to income, for in the opinion of many the surplus belongs to the corporation itself. And, of course, the preferred stockholder is in a worse way yet, for although technically paid as a distribution of income, his claim is actually fixed almost on a par with the bondholder. Indeed, it has been asserted that stockholders themselves "look upon their investment as so much money loaned, rather than that it was used to make them shareholders."²⁶

As a matter of fact, the question could well be asked as to why the contributors of funds, rather than the contributors of labor or land became the shareholders in the first place. Hamilton²⁷ sees it as "an accident of history." Hayek, however, thinks it could be no other way:

. . . it is necessary in the interest of the efficient use of resources that the corporation be regarded primarily as an aggregate of material assets. It is they and not the men whom the management can at will allocate to different purposes, they which alone are the means which it is the task of corporations to put to the best use, while the individual must in the last resort

²⁶T. K. Quinn, Giant Business: Threat to Democracy (New York: Exposition Press, 1953), p. 143.

²⁷Hamilton, Op. Cit., p. 137.

himself remain free to decide whether the best use of his energies is within the particular corporation or elsewhere.²⁸

It has been suggested that in a sense present buyers of corporate securities make the same sort of decision: that they are invited to join in the ownership of a company in the same way that employees are invited to join in the labor force on the basis of certain policies. If they accept, then management's duty is to continue the policy which the shareholders "bought."²⁹

If stockholders do become unhappy, there seems to be an inclination to blame it on poor public relations. Management is inclined, it seems, to conclude that it has failed to "involve" the stockholder. Of course, accountants have probably contributed somewhat to that concept in their insistence on "full disclosure." Although the accounting approach to full disclosure is that management is accountable to the parties at interest, it is but another step to conclude that if the stockholders had adequate information they would understand and be happy. The New York Stock Exchange has published a list of basic information which it feels should be made available to all stockholders of public corporations, whether or not they are listed:

²⁸Anshen and Bach, Op. Cit., p. 103.

²⁹William D. Bowden, "Is Management Guilty as Charged?" The Commercial and Financial Chronicle, Vol. 188 (July 17, 1958), p. 11.

1. The current trend of sales and earnings.
2. Major operating problems facing management.
3. Prospects of any nonrecurring profits or losses.
4. Management's plans for expansion of plant and products.
5. A clear statement of the company's dividend policies.
6. A statement of the Research and Development policies and programs.
7. Any major litigation pending either by or against the company.
8. Any unusual financial matter brought before the board within the preceding six-month period by the independent auditor.
9. Any pending moves of any significance concerning executive personnel or labor relations.
10. Any management intentions to seek new financing.³⁰

"But poor communications is not fundamentally responsible for proxy contests and bad stockholder relations," declares Burrell.³¹ "The primary cause lies in how management behaves and not in how it communicates." And it is certain that this new elite has not been self-effacing or retiring in its conduct. "Capital no longer hires management; management hires capital."³²

Berle has come to the conclusion, along with many other authoritative observers, that although such things as the power of public opinion, the see-saw competition for leadership between oligopolists, and the potential but presently largely unused power of the state, could be called

³⁰Wise, Op. Cit., p. 148.

³¹Burrell, Op. Cit., p. 603.

³²Donald J. Rogers, "The Stockholder: The Neglected Man," The Commercial and Financial Chronicle, Vol. 187 (May 29, 1958), p. 35.

upon to contain and restrain the management of the corporation, present actual limits to corporate power are not effective.³³ "Thus the only real control which guides or limits their economic and social action is the real, though undefined and tacit, philosophy of the men who compose them." The disappearance of the competition of a century ago, and the continued reliance of management upon internal generation of funds to the extent of more than 60 per cent of their capital needs have contributed to the decline of what Dale calls, "the foundations of the free-enterprise system."³⁴ He sees these foundations as being (1) the efficiency insured by competition, and (2) the concept that "where the risk lies, there lies the control."

Potential monopoly and inevitable state control appear to be the future consequences of a lack of management accountability, and we may expect "disintegration of the economic and legal basis for management's existence through the euthanasia of the owners for whom it is supposed to act."³⁵ Reliance upon the philosophy of men in management is not enough. "Like societies before us, we will be ill-advised to rely exclusively on the conscience or benevolence of the

³³The 20th Century Capital Revolution (New York: Harcourt, Brace, and Company, 1954), pp. 25-60.

³⁴Ernest Dale, The Great Organizers (New York: McGraw-Hill, 1960), p. 181.

³⁵Ibid., p. 176.

wielders of power to secure that it be exercised for ends we value."³⁶

The consequences of the absence of accountability are potentially serious indeed, for as someone has said, "The only use for power is abuse." Certain moral consequences can be expected. Such malpractice as misappropriations, etc., are more likely to flourish in the absence of restraint on management, but it is even more likely that legal but unethical excesses, such as questionably high salaries and bonuses, would be more encouraged. Certainly if management can take upon itself the functions of prosecutor, judge, jury and even hangman, a delusion of infallibility would be fostered, particularly when there is no judicial right or appeal.

However, there can be expected to be economic consequences as well. With the loss of independent opinions as a check, personal goals are likely to be favored at the expense of company goals, as for example expansion when unused plant capacity exists. Parkinson's famous law probably has application here, too, and administrative functions would tend to proliferate bringing higher administrative costs. Certainly there is the danger of dissemination of misinformation to stockholders and the general public. Possible danger might lie also in unchecked management's deceiving itself into believing what it wants to believe

³⁶Mason, Op. Cit., p. 45.

rather than what independent judgment of information would lead to, which might permit such things as the wasting away of accumulated past resources.³⁷

It is of course possible that absence of accountability has freed management to be bold and courageous, where the necessity for justification of every act or decision might have resulted in a greater degree of caution and less successful operation. The very complexity of duties wrestled with by management obviously involves the expert use of judgment in the face of risks, many of which cannot even be foreseen. That being the case, management then might be expected to make its share of errors, and the effect of the relentless light of publicity upon the freedom to make future mistakes must be considered. To the extent that full accountability, with its disclosure of unwise as well as wise decisions, contributes to a decline of managerial effectiveness, full accountability might be a very costly luxury indeed for the stockholders.

At any rate it is certain that any move to increase accountability of corporate management to the stockholders would be greeted with great wailing and gnashing of teeth on the part of management. Whether or not stockholder restraint really would intimidate management it would hardly be human nature for them to appreciate restraint and supervision.

³⁷Dale, Op. Cit., pp. 185-195.

Likewise management would certainly resist independent review to eliminate conflicts of interest, for they certainly would not admit to having any. In fact, as mentioned before, entrenched managements are likely to view the whole problem as a matter for financial public relations to train their powerful artillery upon.

Despite the certain objections of management, this paper presents the position that no effective means of assuring corporate accountability to stockholders appears to be presently available. Galbraith's "concept of countervailing power" where great industrial labor unions keep giant corporate oligopolists accountable is interesting but no more permanent and effective than any of the numerous "balance of power" arrangements between nations that history provides.

This paper is concerned with establishing corporate accountability to security holders, principally the common shareholders, to be sure, and assuring them by appropriate means that the fiduciary relationship which should exist between management and stockholder is maintained inviolate.

Numerous suggestions have been advanced for accomplishing this, and a review of them follows.

Peter Drucker suggests³⁸ bringing in experts from business, government and education for the purpose of keeping

³⁸Peter F. Drucker, America's Next Twenty Years (New York: Harper and Brothers, 1955), pp. 49-50.

a watchful independent eye on management, or perhaps actually appointing such men to the boards of large publicly owned companies.

Hayek³⁹ wants to give each stockholder a legally enforceable claim to his share, in order that he might decide annually and on an individual basis how much of his share of the profit he is willing to reinvest. In order somewhat to reduce the power pyramids that exist, where control of huge assets is maintained by means of subsidiary corporations with only a minimum investment, he would also disenfranchise corporate owners of securities--so that corporations could own stock as an investment, but could not exercise control by its own management.

Beardsley Ruml⁴⁰ suggests three specially designated paid directors who would act as "trustees" for customers, vendors, and employees. "Presumably," he opines, "the stockholders, the fourth party, will be the concern of the remaining directors," but just to make sure he would have a fourth specially designated paid director who would be responsible for all stockholder interests.

Justice Douglas urges in Democracy and Finance⁴¹ that directors become full-time paid personnel, but he provides

³⁹Anschen and Bach, Op. Cit., p. 110.

⁴⁰Beardsley Ruml, Tomorrow's Business (New York: Farrar and Rinehart, Inc., 1945), pp. 88-89.

⁴¹The Douglas suggestion and the others that follow are all discussed in Mason, Op. Cit., pp. 54-59.

no assurance of independence from the management who pays them.

Professional stockholders like Lewis Gilbert advocate 'Small Stockholders' Protective Committees or Councils to pool voting strength.

J. A. Livingston suggests the militization of the institutional investor in The American Stockholder. He thinks that the professional investor is not only in a position to make an effective appraisal of management, but can better exercise moral restraint to encourage appropriate reaction to his appraisal. Ernest Dale also thinks that perhaps a national panel of institutional investors could do the job.

Scott Buchanan in The Corporation and the Republic suggests that workers and bondholders be enfranchised as well as stockholders in order that corporations might have a "republican" form of government.

The British Labour Party has suggested that the British government might purchase corporate shares of publicly held corporations in order to achieve legitimacy and accountability through socialism.

Bayless Manning in his review of Livingston's The American Stockholder in the Yale Law Journal in 1958 suggests a "bi-lateral" form of corporate government. A "second chamber," independent of management as to selection, would perhaps be accomplished by delegation of the votes of small

stockholders to a trustee under an indenture, or they could have the option of so delegating their voting rights.

How a truly independent trustee could be agreed upon, however, is a bit of a mystery. At any rate the Small Stockholders' Protective Committees have not been spectacularly successful in achieving influence. Freeing a national panel of representatives of institutional investors from management influence is also somewhat of a problem although this suggestion does show some promise, if the reluctance of institutional investors to participate in management could be overcome. The socialization of industry as suggested by the British Labour Party or in Buchanan's "republican" form of government would be unacceptable politically. None of these, however, penetrates to the heart of the problem. "There still remains the problem of devising ways and means by which corporate responsibility is frankly recognized and positively discharged."⁴²

The solution to this problem, unfortunately, depends upon whether the stockholder is unable to control, whether he has no desire to exercise ownership overview, or whether the problem of measuring management's stewardship effectiveness is so complex that he is bewildered and does not know what to do.

It seems that, although limited by unwieldiness of size which complicates representation of any electorate,

⁴²Hamilton, Op. Cit., p. 138.

stockholders have at present the legal right to control, and that although many may not wish to take an active part in passing on management's stewardship, a great many would if they felt well enough informed and qualified. Perhaps the difficulty of discovering how well management is managing may well be much more significant than any danger of possible disenfranchisement.

Audited reports are required of all publicly held companies, and although they presumably should show the overall result of management's efforts, probably few observers would be so bold as to say they actually do. And certainly even if they do actually show overall results, they make no attempt to evaluate and compare results in terms of what should have been expected.

If it were possible in some way to have an independent annual appraisal of top management, in the same way other employees are now rated by comparison of performance with standard, then stockholders could rely upon that evidence in deciding whether or not to approve management's efforts.

The Certified Public Accountant should be in favored position to provide such a "management audit" because of his long intimacy with a given firm's financial and operating aspects. How feasible is such an audit? Can an auditor develop standards, and apply yardsticks with an objectivity that can be relied upon?

CHAPTER III

LIMITATIONS TO THE MEASUREMENT OF MANAGEMENT ACTIVITIES

The art of management has been exhaustively explored by management theorists, and the personal attributes that contribute to successful management have been identified. This chapter will be concerned with a review of these developments, together with a determination of management activities common to all administrative situations. Whether or not these can be measured, however, depends upon whether standards can be established, and whether measurement techniques can be applied to an evaluation of the effectiveness of management activities.

I. STANDARDS FOR MEASURING

In order that performance of any kind may be compared with some independently contrived measure which is considered acceptable, standards must be established.

"A standard may be thought of as an established measure, something to strive toward, a model for comparison, a means by which one thing may be compared with another . . . "¹

¹Margaret G. Reid, Consumers and the Market (3rd ed.; New York: Appleton-Century-Crofts, Inc., 1942), p. 447.

Standards, of course, are established for several different purposes and permit several different types of comparison. They may describe products, processes, and activities (e.g., "durable paper" could be understood to mean a certain weight or rag content, etc.). They may serve to identify. They may simply measure (e.g., in the designation of a unit which is a definite amount of the physical quantity, or the number of times this unit is used or taken). They may express a reasonably satisfactory level of performance. Certainly their use permits uniformity of products, and is useful in clarifying understanding between the supervisor and the employee, or in settling disputes.²

Nearly every company in nearly every industry is involved in the work of determining standards to a certain extent at least, for interchangeability of parts rests upon standardized production. Some standards, of course, on the other hand are set by professional societies, trade associations or even governmental agencies.

Organizations such as the American Society for Testing Materials, Glass Container Association of America, Electrical Manufacturers' Association, and the Society of Automotive Engineers all assist in defining descriptive terms to be used, material specifications, and testing procedures. Actually all parties interested in a standard usually

²G. R. Terry, Principles of Management (3rd ed.; Homewood, Illinois: Richard D. Irwin, 1956), pp. 492-497 was the source of this material on agencies involved in the formulation of measurements.

participate in its tentative determination, including association members, manufacturers, and consumers. After considering criticisms and suggestions during a trial period, the association membership may vote on its adoption.

Many technical societies, trade associations, and governmental agencies are represented by membership in the American Standards Association, which attempts to work with producers, distributors and consumers in coordinating on a national level the standardizing efforts of several industries.

Actually many governmental agencies such as the U. S. Department of Agriculture and the National Bureau of Standards in the U. S. Department of Commerce have made significant contributions to the establishment of standards by developing measuring methods, and by collecting data affecting the production, sale, and use of various products.

Measurement involves either assigning numbers to objects, or the qualitative assignment of objects to classes. The choice between them is really a decision-making process, and is evaluated by decision-making criteria. In fact, the determination of standards is always a creative activity, and the same type of unstructured situation that will be found to be faced by the executive decision-maker faces the person would set standards. Value considerations must be examined, and the measurer seems always to be caught between at least two desirable aims. The more he tries to emphasize the one, the more he sacrifices another.

His dilemmas may occur in one or more or any combination of the following: (1) Language, (2) Specification, (3) Standardization, and (4) Accuracy and Validity.

1. The more specialized or precise the terminology used, the less widely it is understood. Or, in other words, the "clearer" it is, the more confusing it is to all except experts in the field.

2. The more general the information becomes in terms of use on all things, at all times and at all places, the more costly it becomes to accumulate--and the less useful in a specific context.

3. Precision or standardization is desirable, but it is also helpful to plan for a minimum amount of adjustment when times, places and people change.

4. Accuracy, or the deviation from truth, is relative. Development of general measures of accuracy is at the cost of meaningfulness in specific contexts. Accuracy is defined in statistics in terms of a "confidence interval" (i.e. a certain range of numbers constructed out of observations has a specific probability of including "true" measurement). Usually statisticians would be inclined to have the decision-maker pick his own interval, but consider the implications of having the selected interval either halved or doubled!

Establishing validity of standards presents problems, too. It is not economical, on the one hand to check measurements at every feasible instant; nor, on the other hand, is

it economical to use measurements without any check.

All standards involve construction and use of scales, even though they might be intangible or deal with values.

Scales of measurement may be classified as follows:

1. Nominal--Determination of equality. An example would be the "numbering" of football players.
2. Ordinal--Determination of greater or less. Examples would be street numbers or grades of wood, or intelligence test raw scores.
3. Interval--Determination of the equality of intervals or of differences. Examples would be Fahrenheit temperature, or calendars.
4. Ratio--Determination of the equality of ratios. Examples would be loudness (sones), brightness (brils), time intervals, Kelvin temperature, etc.³

Selection of the scale again, however, requires the exercise of judgment. In fact, analysis always requires the introduction of judgment. Assignment of objects to classes, and developing and verifying sampling theories (to cite examples) involve judgment decisions.

It will be seen that administration requires the arraying of values. Developing standards for their measurement theoretically would not be different from any other problem in measurement, and include the following:

1. Observe and classify the facts.
2. Translate observations and define in terms of standards.

³Charles W. Churchman and Philburn Ratoosh, Measurement: Definition and Theories (New York: John Wiley and Sons, Inc., 1959), p. 25, also 84-93.

3. Establish controls in terms of the developed standards.
4. Coordinate the constraining and regulating factors of control of which the developed standards are a part.
5. Follow up on the standard's use to be sure of its validity.⁴

Since the determination of standards is a creative process, involving the use of value judgments, no standard is any better than the collective judgment of the originators. In measuring such a simple thing as distance, for example, it can only be compared with an arbitrary yard or mile; there is no indication that the distance is good, or the best. Thus no measure of performance can disclose whether performance is optimal, only that it is up to standard. True organizational goals must be reflected in determining the standards or measures to be used in any system of performance measurement or the organization is much more likely to achieve whatever is being measured than what is really sought.

Personnel interviewers might be appraised, for example, in terms of the number of interviews conducted, and thus be encouraged to "rush" the interview which would tend to accomplish exactly the opposite of what was intended. Employees, in fact, always tend to consider performance measures to be indicative of the relative importance of various aspects of their jobs even when used for information purposes only.⁵

⁴Frederick Winslow Taylor, Scientific Management (New York: Harper and Brothers Publishers, 1947), pp. 1-22.

⁵A. H. Rubenstein and C. J. Haberstroh, Some Theories of Organization (Homewood, Illinois: Dorsey Press, 1960), pp. 327-377.

The process of measurement can only disclose the degree of conformity existing between a particular instance and a standard. This comparison is frequently useful, especially when physical characteristics are being compared. Given a sufficiently large number of comparisons, judgment regarding the relative rank of occurrences is not difficult.

Since standards are purely arbitrary, however, and are derived by means of decision-making techniques, standards are obviously of dubious usefulness when required for unique situations, for situations requiring comparison of more than physical characteristics, or for situations which are not well-structured, require value judgments, and are complex in the variety of their requirements.

II. MANAGEMENT RESPONSIBILITIES AND THE MANAGER'S ROLE

Whether management performance can be measured, then, depends upon the nature of management responsibilities and the role of the manager. It depends upon the extent to which executive activities can be classified, and whether there are a sufficiently large number of comparisons available to permit the establishment of standards. If executive activities, on the other hand, involve unique situations which are not well-structured and require value judgments, only limited application of measurement techniques can be made.

Management or administration generally is considered to include planning, organizing, and controlling (or some combinations of equivalent terms). Planning involves "the determination of what is to be done, how and where it is to be done, and who shall be responsible." Organizing is "the process of creating and maintaining the requisite conditions for the effective and economical execution of plans." Control deals with the regulation of organizational activities.⁶

Management Science and Human Relations

Frederick Taylor, Henry Gantt, and Frank Gilbreth brought the engineer's precision to bear upon the problem of management at the end of the last century. The jobs of production workers were studied, standards of productivity for each job were developed, and production scheduling could then be developed and brought to a high level of efficiency. Limits were designated for spans of control, the concept of line vs. staff functions was advanced, and such now familiar principles were proposed as: "One boss per employee," and "Authority must be equal to responsibility." Rational foresight was to replace whim, so that plans would be predicated upon objectives, and action upon plans, and action would be reviewed. Elaborate organization charts proliferated. Job descriptions were developed, and standard operating procedures were emphasized.

⁶Ralph C. Davis, Industrial Organization and Management (New York: Harper and Brothers, 1949), pp. 35-36.

These pioneering contributions were challenged by others who felt them too mechanistic. Professors Mayo and Roethlisberger of the Harvard Business School were critical of too much concern with what they considered purely technical methods of describing management responsibilities, and charged that this approach increased human relations problems.

Productive effectiveness obviously is not the only value to be considered in administration. Continued effective productivity is only possible where achievement values such as morale and group integration are also considered.

A vigorous spokesman for this point of view is Chris Argyris, who considers most administrative procedures to be based on an "inhuman approach." "Organizations," he charges, "are willing to pay wages and provide adequate seniority if mature adults will for 8 hours a day behave in less than a mature manner."⁷ He contends further that there is a lack of congruency between the needs of a healthy individual and the demands of formal organization, and that the results are frustration, failure, short-time perspective, and conflict. These tend to increase as maturity increases, as dependence, subordination and passivity increase, as jobs get more specialized, and as the traditional formal organization principles are brought to bear more rigidly.

⁷Chris Argyris, Understanding Organizational Behavior (Homewood, Illinois: The Dorsey Press, Inc., 1960), pp. 14-18.

Application of these principles causes competition, rivalry, insubordination, hostility, and interest in organizational parts (rather than the organic whole) to increase. Management reactions to these developments (such as increasing directive leadership and management controls and developing pseudo-human relations programs) tend only to increase the tensions and antagonisms.

Indeed a certain number of details, clerical routines and regulations is necessary in any sizable organization in order that individual parts or functions may be kept pulling toward common overall goals. Certainly customers, for example, have a right to expect time tables to be constructed for transportation companies, and employees expect to follow them as nearly as possible.

It is possible that a certain amount of "pressure" results from these, and yet mild frustrations seem at times to increase effectiveness. Abraham Lincoln may well be an example of that; had there been a sufficiency of today's educational aids available to him, there might have been no Lincoln. Ineffective organization, in fact, may lead to even worse frustrations because predictable routines cannot be formed, and overt or suppressed conflicts and dissatisfaction develop. Actually both the management science approach and the human relations approach are necessary and neither can be ignored, for it is in their combination, the organizing of the efforts of other individuals, that

management effectiveness is to be found. "Management is a responsible process, of guiding and regulating the activities of other people, and its criterion is the effectiveness of their operations."⁸

Executive Goals and Attributes

The goals of a corporation have been suggested to be:⁹

1. Those related to its legal perpetuation.
2. Functional--i.e. the supplying of products or services needed by the consumer.
3. Technical--i.e. those involving the maintenance of technological superiority.
4. Profit-making. Here, long-run profit could be preferred over short-term windfall profits, and "excess" profits could be defined in terms of the erstwhile Excess Profits tax.
5. Personal--i.e. everyone wants "to stand well in the eyes of those whose approval we desire."
6. Public--i.e. consumer acceptance, and public relations.

Executives, however, are human beings and would tend to personalize such goals, and to value influence and power, respect, affection, industry position, and status as much, perhaps, as they do profits and dividend maintenance. The aims of the corporate managers, then, may be more important than corporate goals, for, in order that the company may grow rather than shrink, the chief executive must see that the company performs well in many areas. If the executive's

⁸Edward Franz Leopold Brech, Management, Its Nature and Significance (2nd. ed.; London: Pitman, 1959), p. 138.

⁹Ordway Tead, The Art of Administration (New York: McGraw-Hill, 1951), pp. 12-21.

personal goals are to be met, he must see that production of quality products is maintained, that employees, suppliers, and customers are dealt with fairly, and that investors are paid a good return. Public relations and advertising cannot substitute for good performance. So indirectly even stockholders benefit from management's personal goals.

Studies have been made attempting to identify the type of person who succeeds to positions of management responsibility, and to itemize common characteristics.¹⁰ A high degree of creativity seems frequently to be present, and creative people seem to have a high problem sensitivity, an ability to recognize and grasp the dimensions of a problem which only causes other people to despair. Idea fluency appears to be another characteristic, by means of which a creative person is able to reduce ideas to manageable proportions and to communicable servings. Originality, flexibility, and drive are three additional characteristics which seem generally to be present. A creative person usually also has what might be called "redefinition skill" (the ability to reinterpret factors and situations in the light of subtle changes) and abstracting ability, as well.

Johnson O'Connor attempted to show how executive abilities could be measured, but he concluded that the executives he studied measured so high over such a wide range that his

¹⁰Joseph G. Mason, How to be a More Creative Executive (New York: McGraw-Hill, 1960), pp. 33-45.

proposition was impossible to validate. He found five characteristics common to men and women in executive positions.¹¹

- A. Large English vocabulary (generally larger than the group supervised.) This is considered essential to communication and creative thought.
- B. Many aptitudes (these include tonal memory, and finger and tweezer dexterity as well as others of critical importance listed separately below).
- C. Objective personality. (Rather than subjective.)
- D. Accounting aptitude. (Quantitative skills.)
- E. Aptitude for first position. (This was considered important in that such aptitude gives confidence for meeting increased responsibilities.)

Executive attributes may be described in terms of moral hazards.¹² Executives have to learn to live with compromise and to be willing to take the consequences of executive action, for things never work out in an entirely satisfactory fashion. They rarely have the privilege of being completely open, and of enjoying the luxury of the truth, the whole truth, and nothing but the truth. They must learn, too, to accommodate to the finality of their own decisions; in other words, "the buck stops there," but they also are responsible for the errors of subordinates. Of course, the illusions of praise, and the desire for cultural development, may influence the direction of corporate activity away from that dictated exclusively by stockholder considerations.

¹¹Johnson O'Connor, Psychometrics; A Study of Psychological Measurements (Cambridge, Mass.: Harvard University Press, 1934), pp. 3-22.

¹²L. W. Norris, "Moral Hazards of an Executive," Harvard Business Review, Vol. 38 (September-October, 1960), pp. 72-79.

Executives thus are seen as persons of superior skill and sensitivity whose personal goals are met in a general way by good management performance, but who may be influenced by personal considerations to weight corporate goals differently than they might be weighted by stockholders themselves.

Trends in Management

A combination of factors has served to distinguish professional management from the owner who supervises the activities of personnel reporting directly to him. The professional manager arrived on the scene only after the growing pains and early development of the enterprise are long past. The owner, on the other hand, who directs his own enterprise is generally steeped in its history, if not actually involved in its growth. He has seen his plans unfold; he has tried and failed and tried again. Perhaps, as was rumored of the elder Henry Ford, he does not trust any one else's judgment. He tends, even under ideal circumstances, to originate plans himself, to be the spring from which ideas are fed. The professional manager may initiate some plans, but perhaps more often serves as the arbiter or judge of alternatives which are conceived at lower levels and passed up to him for selection. The chief executive in a large publicly held corporation thus tends to become a coordinator.

Although the manager's own capital is not in large part committed by his acts, they cover a vastly increased

scope of activity with really far-reaching implications, some of which are enumerated by Berl in The 20th Century Capitalist Revolution as follows:

1. Corporate management possesses extensive power over the activities of subordinate officers and employees by being able to give or withhold employment and by being able to influence industry-wide wage standards and labor relations.

2. Far-reaching power over whole cities and areas results from management's authority to determine location and migration of operations.

3. Management decides what markets to supply, what wants to attempt to create through advertising, what products or services to promote, and what regions will develop and which will remain static.

4. Technological development is encouraged or bottled up according to the will of corporate managers.

5. Basic economic, political, and social attitudes can be conditioned by corporate managers to the extent that public opinion may be formulated. The effect of "administered prices" on the economy, for example, is a significant influence indeed.

6. The extent and rate of capital investment is determined, not to be sure by any single corporation, but certainly by the largest few.

It is not only the increased scope of management activities, however, which has complicated management's task, but other factors also have been involved. Planning for example is more difficult all the time because of the rapidity of change. Planning tends to be circumscribed, too, by internal inflexibilities such as capital investment, and psychological resistance to change or to abandon established procedures and policies. External inflexibilities such as technological change, political change, and the pressure of organized labor add further difficulties. Even time and expense hamper planning.¹³

Management very likely soon will need increasingly to face such developments as these:¹⁴

1. The trend is towards a management of change--of innovation.
2. Future managers will tend to share in shaping the environment and the future of their businesses.
3. Decisions will have a longer range impact.
4. The emphasis will be on objectives, effective planning and strategy, and on organization. It will also emphasize using the results of measuring to adjust the planning, organizing, operating and the measuring itself to changing demands and conditions affecting the business.
5. Management will think in terms of systems, processes and relationships.
6. More attention must be given to management development.
7. The external impact of decisions will be increasingly important.

¹³H. H. Koontz and Cyril O'Donnel, Principles of Management; An Analysis of Managerial Function (New York: McGraw-Hill, 1959), pp. 571-578.

¹⁴George C. Houston, Manager Development, Principles and Perspectives (Homewood, Illinois: Richard D. Irwin, 1961), pp. 85-88.

8. There will be an increased concern for the internal business "climate."
9. There will be an increased market or consumer orientation.
10. More attention will be given to the creation and utilization of capital funds essential to short-term and long-term business requirements.

Each, of course, can only serve to make management's task more difficult and to render more complex the problem of evaluating performance.

Perhaps, however, new techniques are developing which will reduce a significant part of management's problems to standardized formulae. How much will mathematical or scientific techniques be used in solving business problems? To what extent will human judgment be replaced by a computer?

New methods of handling company information processes are now being proposed. As a result, middle and lower management may soon be supplied with increasingly complete and exhaustive sets of rules and policies. They may be told what problems to attempt to solve and what problems to transfer to others. With expert staff assistance in scheduling, inventory control, marketing, and investment planning, central headquarters conceivably will reclaim the functions assigned to others in the past decade of decentralization.

The new study of "cybernetics" which is defined as the science of control and communication, has received some attention recently. It has been predicted that since nearly

two millions of workers are being displaced yearly by automation, there is becoming less and less need for foremen, supervisors, and middle management generally. In what might be called a "cybernated" society, high-powered repair crews will be needed instead (plus sophisticated, engineering-minded top management) to cope with and improve the machines. In other words, more work for top management, and less need for junior executives.¹⁵

The familiar techniques of Operations Research have developed into such things as "Minimax-maximax" strategy. This strategy is designed to help "economic man" (if he indeed exists) take advantage of the personal bias of his scale of values, so he may select from among alternatives the most rewarding one in the light of the decision-maker's own attitude toward taking chances. This can be formulated mathematically. "Minimax" involves the least risk of disaster (and the most meager fruits of victory) and would be prudent for the pessimist or against a shrewd, tough opponent. "Maximax" is for the optimist, who is willing to take big risks, in order to make big gains. For the gambler who takes the bitter with the sweet and expects to average out in terms of maximum profits in the long run there is the "maximum expected value" strategy.¹⁶

¹⁵Donald N. Michael, Cybernation: The Silent Conquest (Santa Barbara, California: Center for the Study of Democratic Institutions, 1962),

¹⁶George A. W. Boehm, "Helping the Executive to Make Up His Mind," Fortune, April, 1962, pp. 128-31ff.

Two new scheduling procedures also have met with striking success: Critical Path Method (CPM) and Program Evaluation and Review Technique (PERT), which differ from each other in only a few details. Many projects involve a vast number of details, simple in themselves, but complex in their number and variety, and difficult because of their inter-relation--e.g. when to order materials, when to hire employees, when to promise completion. Both of these scheduling systems involve analysis of all work into individual tasks, estimated as to time and cost. A network of these is diagrammed to establish what work must await completion of other tasks and what can progress simultaneously with the others. The manager is thus freed from mathematical details, but finds most decisions almost automatic within a broad framework allowing wide latitude for the exercise of his judgment.

Applications such as this would suggest the feasibility of using computers to make a great many middle management decisions that until recently were thought to require the experience and judgment of specialists.

Generally, attempts to use mathematical or scientific methods in the solving of business problems have sought first to eliminate the judgmental aspects of a problem and to reduce them to situations upon which a formula is applicable. Exception, however, can be taken to this procedure.¹⁷

¹⁷Eugene Raudsepp, "Can You Trust Your Hunches?" The Management Review, Vol. 49 (April, 1960), pp. 4-9ff.

Most business problems of any importance involve value as well as factual characteristics, and moreover the value characteristics are difficult to isolate. If omitted, though, some essential elements are not considered. Further, problem-solving techniques themselves call for simplification of the problem in order that it may be made to fit the technique. Even where the situation might be predominantly factual, however, no existing technique is able to attempt to solve it without breaking it down into parts, which disturbs the validity of the solution. Proponents of the new techniques can be criticized for maintaining that only through their use can management handle the increasingly burdensome tasks it faces, when in reality a complex situation with many variables calls for precisely the synthesis of which intuition is capable. All of these techniques, also, are actually useful only in static situations, which do not occur in the business world.

Some work has been done, however, in the area of measuring values themselves, and the following applications have actually been made of these measurements:

1. To establish a priority list for equipment requested by various departments.
2. To assign values to criteria used in selection of public housing sites.
3. To evaluate the relative importance of product characteristics in new product development.
4. To assign relative weights to manufacturing defects, which could occur in a product.
5. To evaluate the following firm objectives in order to make decisions on long-range plans.
 - a. Security of existing management.
 - b. Financial security.

- c. Financial opportunity.
- d. Security and promotion of key personnel.
- e. Labor stability.
- f. Technological leadership.
- g. Community service.¹⁸

Certain assumptions must be made, however, before values can be measured:

- 1. That the decision-maker will be able to rank the outcomes.
- 2. That the ranking will be transitive.
- 3. That meaningful assignments can be made to points on a zero-to-one scale.
- 4. That the values thus attained are additive, i.e. the value of a combination of two outcomes is the sum of their individual parts.

These assumptions obviously may well be unrealistic for many value judgments, even though a systematic and organized way of checking the internal consistency of the judgments thereby results.

It is true that all of these techniques do have some useful applications, and the use of the computer has been of assistance in making them more useful. As computers are more widely used, additional applications are found for them. Computers are really very general devices capable of manipulating word symbols as readily as numerical symbols, and technicians are only now learning how to communicate with them in language (such as FORTRAN) which is very similar to the ordinary language of mathematics. These programs are called heuristic programs, and they can be devised to make

¹⁸Charles W. Churchman and R. L. Ackoff, "An Approximate Measure of Value," Journal of the Operations Research Society of America, Vol. 2, No. 2 (May, 1954), p. 424.

computers behave adaptively, i.e. to improve their own programs on the basis of their experiences, or in other words, learn. Actually, computers can now be programed to solve relatively ill-structured problems through methods very similar to those used by humans. They discover proofs for theorems in geometry, they play chess, they even compose music. Sometimes they simulate detailed human processes; sometimes they utilize shortcuts, but it could be asserted that more understanding of human problem solving results with their increased application.

It does indeed seem that the tasks traditionally performed by middle management, which frequently involve repetitive choice among well defined alternatives, can be facilitated by these new techniques. The tasks of top management, however, are not well-structured, generally require value judgments, and involve wide scope in their complexity. It seems as though the new techniques will have relatively little impact upon their jobs, except perhaps to shed some light and understanding upon improving the capacity to solve management problems.

III. MANAGEMENT ACTIVITIES

The management functions previously described (such as planning, for example) actually defy precise description and render the possibility of measurement almost hopeless. A more useful definition of management responsibilities may be

in terms of the executive's activities: he decides things, and follows through. In other words, he is involved in decision-making and control. As the making of decisions and the assurance of their execution by means of control or follow-through seem to represent observable executive activities, they will be examined in order to ascertain whether their effectiveness can be measured.

Decision-Making

Although outwardly confident, executives are actually uncertain and insecure about the effectiveness of the decision-making process. When pressed to explain a decision, an executive might find it difficult frequently to marshal supporting facts and rational thought processes, and intuition may seem to have played a strong part in the making of the decision. Intuition has been defined as:¹⁹

the capacity to arrive at conclusions or to make correct decisions and judgments without consciously formulating all the premises, or without a full conscious awareness of the reasons for the decision or judgment. It is a form of reasoning where the weighing and balancing of evidence is carried on unconsciously.

Since many decisions cannot be made in leisurely, reflective fashion, deadlines or pressures tend to favor intuition against analysis. Decisions are more likely made on the basis of snap judgment, unorganized experience and

¹⁹Raudsepp, Op. Cit., p. 4.

implicit processes of choice when they must be rushed, and there tends to be less use of staff personnel. Formal decision-making in terms of logical, orderly procedures may be somewhat uncommon because of this pressure of daily events. Thorough examination is almost never made of all the premises, or alternatives, and even when it is, the decision maker may not always proceed logically. Some of the tools of formal logic are frequently used, however, even though they may not be recognized as such, and an examination of some of the terms and concepts used in logic may be helpful for this study.

A premise can be considered a description of a cause and the result deemed pertinent to the alternative being examined. The factual element in a premise (a piece of information described or measured by an objective or generally agreed-upon measuring rod) can be distinguished from the value element in a premise, which is a piece of information described or measured by someone's own privately designed measuring rods (accumulated from his own total experience). There are several techniques that can be used in dealing with premises in selecting an alternative, assuming that one is sought which will supply the greatest total (aggregate) weight of desirable results and the smallest total amount of undesirable results. If two or more alternatives seem equally satisfactory, a coin might as well be tossed. If no single alternative seems suitable, perhaps some can be

combined. If unwanted consequences seem to be large and disagreeable, the premises can be weighted. If there are too many premises, they may be organized into three or four homogeneous ones. And if none are satisfactory, new ones should be sought.

An inference is the mental process by which decisions are drawn from premises, and implications are the relation between premises, e.g. the truth or falsity of one premise may limit the truth or falsity of other premises. Implications exist, of course, whether or not they are ever discovered, and they must be discovered for they are unlike the inference, which results from mental processes.²⁰

Reasoning from individual instances to a general conclusion is called induction. It may be enumerative (an inference from enumeration of instances) based on a limited number, or particular instances enumerated completely, e.g. metal conducts heat. It may, on the other hand, be scientific: intellectual where instances are considered and insight into particulars gives assurance that a universal is true, or rational where a consideration of particulars leads to a universal judgment because it is thought necessary even though the reason for the necessity may not be seen.

Deduction, conversely, leads from the general to the particular. It requires premises, but it is induction

²⁰Robert William Morell, Logic for Decision-Makers (Detroit: University of Detroit, 1958), p. 93.

which furnishes the factual material and generalizations to serve as premises.

The syllogism is a "form of reasoning or inference which derives from two given premises a third proposition, a conclusion or decision whose validity follows from the two premises as a necessary consequence."²¹ It must be noted that ". . . deductive logic does not concern itself in any way about the truth of the premises, but only about the cogency of the argument."

Much of what passes for intuition, of course, involves the use of some of the methods of formal logic, although the decision-maker is not familiar with the terms used in logic, and does not identify the steps involved in his reasoning. What may appear, however, to be hunch or intuition on an executive's part is not really relied on so much as a knowledge in depth of the forces that influence decisions and his own experience in reaching previous decisions. Actually a number of factors appear to be involved. Getting successful experience early in life, testing past experiences and getting new ones, gaining a sense of when to stop looking and start acting, and so on, all become a part of an executive's background. Since the known facts are never complete, a facility must be developed for interrelating them and

²¹Robert William Morell, Managerial Decision Making: A Logical Approach (Milwaukee: Bruce Publishing Co., 1960), p. 58.

testing them against past experience in order to move confidently toward a new decision.

Decisions of course are not of uniform difficulty, and may be separated into tactical, and strategic decisions.²² Tactical decisions are always one-dimensional. The situation is given and the requirements fairly evident. The problem can be reduced to finding the most economical adaptation of known resources. Established procedures such as communication, command channels, work simplification, personnel selection, morale-building techniques, team organization, and conference methods are satisfactory in the solving of these day-to-day problems. Familiar principles are applied to a particular situation, in other words.

Strategic decisions, on the other hand, are subjective and involve formulation of new principles through conscious thought processes. These decisions are likely to affect institutional development, define corporate goals, shape the character of the firm and defend its integrity and identity. They cannot be made through the use of any known or yet-to-be-developed problem-solving techniques, for the decision-maker is not hunting for the right answer so much as hunting perhaps instead for the right question.

²²Peter Drucker, The Practice of Management (New York: Harper and Brothers, 1954), p. 352.

This is indicated by research on actual decision-making in a large corporation.²³ The rational choice process of economics may be described in this manner:

1. An individual is confronted with a number of different, specified alternative courses of action.
2. To each of these alternatives is attached a set of consequences that will ensue if that alternative is chosen.
3. The individual has a system of preferences or "utilities" that permit him to rank all sets of consequences according to preference and to choose that alternative that has the preferred consequences. In the case of business decisions the criterion for ranking is generally assumed to be profit.

In actual experience, however, it was found that several elements are missing in typical situations: (1) Alternatives are not usually apparent, but must be discovered. (2) Consequences are rarely obvious for the various alternatives, and must be sought. (3) Comparison among alternatives can rarely, if ever, be made on the basis of a single criterion such as profit, because possible consequences are frequently intangible. A satisfactory alternative (rather than the "best") must usually be the solution in order to attain a specified goal without disturbing a number of auxiliary conditions. (4) Often the problem itself is not "given," but an important organizational task is the searching for significant problems to study.

²³Richard M. Cyert, Herbert A. Simon, and Donald B. Trow, "Observation of a Business Decision," The Journal of Business, October, 1956, p. 237.

Of course, the experience and ability of the decision-maker himself helps determine whether a decision is tactical or strategic, in addition to the intrinsic characteristics of the situation, for what seems a strategic situation to a neophyte is frequently tactical or routine for the experienced executive.

Decisions regularly involve both ends and means, but they must be differentiated because ends deal with value judgments or are ethical, whereas means can be arrayed by rational methods of thought. Ethical implications are always involved in decision-making, for one course of action is always asserted as better than another when a decision is made, and it is the appropriateness of the relationship between the means and the end which makes a decision "good" or "bad," for

. . . it is not the decision itself which is evaluated, but the purely factual relationship that is asserted between the decision and its aims. The commander's decision to take particular measures in order to attain surprise is not evaluated; what is evaluated is his factual judgment that the measures he takes will, in fact, attain surprise.²⁴

In fact, if the executive relies on a staff for the achievement of objectives, most issues will be substantially settled before they reach him; he decides primarily what to decide and what to delegate.

²⁴Herbert A. Simon, Administrative Behavior: A Study of Decision-Making Processes in Administrative Organization (2nd ed.; New York: Macmillan, 1957), p. 49.

Sometimes the selection is tempered not so much by the bias of subordinates, though, as by the conflict of interest between the decision-maker's own preferences and those of individuals who share, in a measure, responsibility for decision-making. Purely chance events, and forces over which he has very little control such as his own personality and outlook on life, his response to incentives, and the institutional framework within which he is to provide leadership, all influence decisions.

Uncertainty actually is the element in decision-making that complicates the measurement of its effectiveness. The reaction of the decision-maker or his staff subordinate to uncertainty is the part of the problem which seems difficult to render into mathematical terms. People must assume that things which are similar in some respects will behave similarly in certain other respects even though they are very different in still others. The pattern or lack of it, however, defies definition, for although it is possible to predict the total number of fires with great accuracy it is impossible to predict which house will burn. Patterns are elusive, too, because many events are really significantly different from all past events (or there are not a statistically significant number of past events), and because there are not a large enough number of future events foreseen.

Professor Shackle of the University of Liverpool views decision-making as entirely creative or imaginative because

of the problem of uncertainty. Thus he sees the weighing of alternative outcomes not in terms of mathematical precision at all, but rather in terms of the most exciting possible results imaginable, and the most alarming results conceivable. He insists that no array of alternatives is possible but that each is viewed creatively in terms of extremes of consequences, both good and bad. This he calls the "theory of potential surprise." An enterpriser in deciding whether or not to invest will

. . . weigh against each other the two elements of the immediate mental experience which this position would afford him: the enjoyment by anticipation of the greatest gain whose attractiveness is not undermined by association with too high a degree of potential surprise, and the suffering, by anticipation, of the greatest loss whose unpleasantness is not weakened by being associated with too high a degree of potential surprise. It is these two extremes which will focus the enterpriser's attention.²⁵

Uncertainty is different from risk (where the probability of outcome can be predicted, and insured against) because imperfect knowledge of the future exists. It is purely subjective in that insufficient historical data is available upon which to compute probability, and no two managers will form the same mental vision of the future, or be able to verify their conclusions.

There are, to be sure, different degrees of uncertainty and an attempt has been made to enumerate them:

²⁵G. L. S. Shackle, Expectations in Economics (Cambridge: The Cambridge University Press, 1949), p. 5.

1. Subjective certainty (this is rare) where only one possible outcome is foreseen.
2. Subjective risk, where a range of outcomes is foreseen.
3. Subjective uncertainty, where multiple outcome distributions are foreseen, predicated in turn on probability expectations of structural changes in economic environment.²⁶

These differing degrees of uncertainty, however, mean that mathematical and scientific procedures are called for in addition to inspiration or invention. The fields of medicine and engineering may be cited as evidence of how both research and application are necessary in a profession, for ". . . the scientist himself is a decision-maker . . . The scientist decides what to study; he decides what model is adequate within which to pose his problem; he decides how, when and where to make observations; he decides when to accept or reject a conclusion."²⁷ "The decision-maker is . . . (also) still essential, because someone has to make the leap in the dark and take the risk, even with a scientist at his elbow."²⁸

Decision-making, then, is still essentially creative, involving value judgments, intrinsically that do not lend themselves to any great extent to mathematical or objective techniques of solution.

²⁶Milton H. Spencer and Louis Siegelman, Managerial Economics: Decision-Making and Forward Planning (Homewood, Illinois: Richard D. Irwin, 1959), pp. 9-12.

²⁷Charles W. Churchman, Prediction and Optimal Decision: Philosophical Issues of a Science of Values (Englewood Cliffs, N. J.: Prentice-Hall, 1961), p. 14.

²⁸Ibid., p. 10.

Control

"Control is the process by which management assures itself, insofar as is feasible, that what the organization does conforms to management's plans and policies."²⁹ It is expected that the person to whom responsibility or authority is delegated will report back in detail as to the discharge of his responsibilities, or in other words be accountable. Within the typical large American corporation quite an elaborate network of delegation exists, from top management, to middle management, to supervisors, etc. Control is the nervous system that binds together this network, and, since the accountability of many subordinates is expressed in terms of money or units of time or material, it is closely related to financial or operating data.

Planning for control is ordinarily assigned principally to the corporate controller, in addition to the work of financial planning, tax administration, and evaluating, interpreting and reporting the results of operations. Since this assignment represents delegation, however, the controller does not really "control" for his authority and responsibilities have been delegated to him by line management.

In effect, the overall corporate plan must be reformulated in terms of individual responsibilities, and these must be discharged within established parameters as to costs and

²⁹Robert N. Anthony, Management Accounting (Homewood, Illinois: Richard D. Irwin, Inc., 1956), pp. 4-5.

investments through a quantification of goals. The accounting tools of forecasting, budgeting, standard costs and auditing thus have been developed to facilitate control. Accounting and statistical reports have supplanted the personal observation and supervision that can be given by the owner himself in small plants. They help "to maintain the pressures necessary for efficiency and to expose unfavorable variations and trends," to guide and regulate "business activity through the measurement of performance."³⁰ Even the American Management Association acknowledges, " . . . the financial function must assume leadership in making recommendations as to reasonable financial objectives as well as the financial appraisal of the effect of major marketing and production objectives."³¹

In control, four successive actions are required. (1) Here it is that standards must be established and used. Specific measurable units must be devised for each operating unit, reflecting firm objectives. (2) Authority must be delegated. (3) Performance must be inspected, both in relation to the goal and to the cost. (4) Finally appraisal must follow all this.

³⁰J. B. Heckert and J. D. Wilson, Controllershship: The Work of the Accounting Executive (New York: The Ronald Press Company, 1952), p. 17.

³¹American Management Association, New Perspectives on the Administrator's Job (New York: American Management Association, 1952), p. 13.

Accounting records are vital in comparing actual results with predetermined standards, in comparing performance with that of others in comparable jobs, and in judging adequacy of performance in terms of past performance. The development of the individual standards, however, and the overall plan (which is quantified in the budget), does not only involve obtaining the expected results from hundreds of activity centers. There are necessarily intricately inter-related, and ways and means must

. . . be found to establish and use effectively channels of communication between the front lines of sales and production, the field headquarters of line-operating executives, and the general headquarters of top management . . . a modern business of any substantial size cannot be managed intelligently without a continuous and organized flow of information about the environment in which it functions, its operating plans, and the actual results of its operations. It is in organizing and maintaining this flow of information that controllership can make its most significant contribution to executive management.³²

It is obvious, of course, that company control relies not only upon information about such internal matters as forecasts for all activities and their results, costs of all products, departmental expenditures, and the assessment of the achievement of the overall plan, but upon certain external information. Factors affecting a particular business or a specific industry must be estimated, as well as the factors affecting national and international trading. It is true, too, that control is not necessarily expressed

³²Thornton F. Bradshaw and Charles C. Hull (eds.), Controllership in Modern Management (Chicago: Richard D. Irwin, 1949), pp. 46-47.

in any single particular way. Any activity can be controlled with respect to any one or all of the following factors: quality, quantity, cost, or time use.³³

In addition to summarizing the comparison of performance with established or budgeted standards, and serving as the unifying force that serves to enlighten organizational parts regarding their role in the organic whole, control necessarily involves "taking steps to correct discrepancies which occur."³⁴ Furthermore, deviations from plans must be detected early enough that corrective action is possible, and they must be detected with a minimum of unsought consequences. Control should aim, in fact, toward foreseeing future deviations, as well as unearthing present and past ones.

An important point is made by Lemke and Edwards³⁵ that control is really passive to the extent that it only reports the progress made in carrying out a decision by comparison of the plan with the results produced; to the extent, however, that the purposeful activities of assuring compliance occur, control should and does play an active

³³G. R. Terry, Principles of Management (3rd ed.; Homewood, Illinois: Richard D. Irwin, 1956), p. 474.

³⁴Dalton E. McFarland, Management Principles and Practices (New York: Macmillan, 1958), p. 299.

³⁵B. C. Lemke and J. D. Edwards, Administrative Control and Executive Action (Columbus, Ohio: C. E. Merrill Books, Inc., 1961), pp. 4-5.

role in administrative activities. The active role is of increasing importance, too, in the application of control because of the growing complexity of managerial problems.

To the extent that control goes beyond the comparison of performance with established standards, and tries to anticipate deviation or to take corrective action to assure compliance with established policies, it becomes a decision-making activity and is subject to the same measurement problems. Although comparison of performance with standards poses no great measurement problem, the establishment of the standards or objectives themselves presents a certain amount of difficulty even with relatively low-level employees.

It is here, of course, that the difficulty in rendering top management accountable centers, because, unlike the inventory clerk whose duties are observable and routine and whose performance can be fairly readily compared with his planned activity, top management's duties are creative rather than routine. Value judgments are involved, and even though top management's "control" of subordinates is an element in determining management effectiveness, the same principles cannot be used to control management itself or make it accountable to corporate ownership.

IV. EVALUATION OF ATTEMPTS TO MEASURE MANAGEMENT ACTIVITIES

Despite the obvious difficulties, some attempts have been made to set standards of performance for executives in

much the same manner that job evaluation occurs at lower levels. Although authorities recognize the difficulty in rating top management and its policy-setting role, they have continually pushed job descriptions and other techniques of performance rating up just short of top management perhaps largely because they realize that middle management is being rated anyway, and that any devices that might sharpen judgment are desirable.

The approach in evaluating middle management, however, is slightly different from that used for factory workers because the goals are somewhat different. Performance is reviewed against established goals and standards, but the qualifications of the present as well as future jobs are reviewed, and areas of weakness requiring strengthening for this and future jobs are sought. This reveals perhaps another reason for excluding top management, for they presumably have no future jobs, having "arrived"; they are in fact developers of men rather than developing themselves. It may also be felt that the results of top management performance are more apparent, and that routine appraisal is less important. There is also the extremely touchy situation where the top man would have to be appraised by some one subordinate in some way at least, unless the appraiser were completely independent.³⁶

³⁶Carl Heyel, Appraising Executive Performance (New York: American Management Association, 1958), p. 17.

Examination of company plans reveals that appraisal (frequently including self-appraisal) and discussion and coaching are used for even fairly responsible positions--but not for top management itself.

Standard Oil of California, for example, includes in its executive position evaluations such factors as detailed functions, most important contacts, special requirements as to education, training, knowledge, etc., the kind and level of supervision and functional assistance required, and the responsibility and authority over men, materials or products, operations or functions, equipment, money and business relations.³⁷

GE's Missile and Ordnance Systems Department establishes accountability factors, and has appraisals by the immediate superior, which are reviewed by the reviewer's superior before discussion with the employee himself.³⁸

Executives of the Detroit Edison Company are appraised by their superiors as to results, personal qualifications, and future potential. A procedure similar to this is followed by Atlantic Refining Company, except that a representative of the Industrial Relations Department shares in the appraisal, which includes such additional criteria as motivation, emotional stability, and effective use of

³⁷John A. Patton and C. L. Littlefield, Job Evaluation (Homewood, Illinois: Richard D. Irwin, Inc., 1957), pp. 283-285.

³⁸Heyel, Op. Cit., pp. 162-163.

intelligence. Over 4,000 executives of the New York Central System are appraised by their immediate superior and two other executives on the same level as the superior, who may be selected by the person being rated.³⁹ Other formal evaluation systems are undoubtedly in use in many other companies as well.

Ernest Dale has experimented in attempting to draw up top management job descriptions. He names the following highly subjective criteria, for example, for establishing the accountability of the company president:

1. To obtain the optimum profit and return on the investment of the company over the long run.
2. To obtain and maintain the optimum percentage of the potential market sales for major products of the company.
3. To maintain at all times the optimum class, type, design, and quality of products, approve new products, and assure the optimum service of all products of the company.
4. To obtain the optimum utilization of expenditures.
5. To assure fulfillment of operating budgets and foster economy.
6. To assure efficient management throughout the company.⁴⁰

One frequently overlooked difficulty in preparing job classifications for top management would be that the same job may entail different responsibilities when held by different people. It may be noted that companies occasionally seem to compensate for underdeveloped functions when they seek a top-executive replacement; if the former president

³⁹Ibid., pp. 163-167.

⁴⁰Ernest Dale, Planning and Developing the Company Organization Structure (New York: American Management Association, 1952), p. 175.

was sales-minded, his successor may be a finance man, etc. The nature of a given executive position tends, it seems, to reflect the qualifications of the incumbent.

In addition, however, to the problems inherent in measuring top management performance, executive personnel problems are quite distinctive in a number of other aspects, and presently developed standards are inadequate for these additional reasons: (1) There are only a relatively small number of people involved. (2) Personal relationships are close and intimate. (3) Problems are primarily long-run, rather than short-run. (4) Costs as well as results of executive personnel work are difficult to quantify, and uniformity of agreement as to goals is difficult.

The American Management Association (which serves primarily to encourage and disseminate management education through its conferences and workshop classes) has no program whatsoever for evaluation of management performance and makes no attempt at appraisal of managerial personnel. This may unfortunately be related to its apparent lack of interest in developing management principles as such, but instead to place greater stress on management participation in the exchange of administrative experiences.

The American Institute of Management, on the other hand, under the energetic direction of its founder and Chairman of the Board, Jackson Martindell, has developed what is meant to be an equivalent in the field of management

to the financial audit of Certified Public Accountants. By means of a check list of 301 questions, data is compiled for analysis and evaluation, and this is supplemented by interviews with executives, directors, employees, suppliers, competitors, customers, and stockholders. Ten individual categories are appraised and overall performance of management is judged from these (the optimum points that can be earned out of a total of 10,000 are also listed):

- Economic Function--the public value in terms of reputation and management goals. 400 points.
- Corporate Structure--organization, and divisional and subsidiary relationships to central management. 500 points.
- Health of Earnings--ratios of earnings to sales and assets, and consideration of adequacy of depreciation and maintenance provisions. 600 points.
- Service to Stockowners--policies and practice regarding stockholder relations. 700 points.
- Research and Development--organization, expense, and evaluation of research results, and management's role in these. 700 points.
- Directorate Analysis--the degree of activity of the board. 900 points.
- Fiscal policies--capital structure, means for developing fiscal policies and controls, and evaluation of these. 1,100 points.
- Production Efficiency--labor relations, materials handling, assembly line methods, etc. 1,300 points.
- Sales Vigor--sales techniques to exploit markets evaluated. 1,400 points.
- Executive Evaluation--consideration of personal qualities of ability, industry, and integrity. 2,400 points.

Few would argue as to the importance of these considerations, but conversely, few would agree as to the optimum conditions applicable to each. For example, "conservative" financial management would generally be considered desirable, but Martindell's definition of that would place him at odds

with most business finance theorists and practitioners:

" . . . superior management does not borrow on long term except as a last resort," he states.⁴¹ As another example, he emphasizes in his management audit reports the age and other business connections of directors, and seems to feel that an "outside" board of directors is desirable. Wide agreement perhaps would be difficult here, also.

Audits by the American Institute of Management have been published for such companies as Procter & Gamble, Minnesota Mining and Manufacturing, Maytag, Eastman Kodak, National Cash Register, Humble Oil, Alcoa, and Southern Pacific. Such audits have also been published for other organizations such as the Roman Catholic Church, the Pennsylvania Military College, and the Baptist Hospital in Pensacola, Florida. Separate categories with different optimum numbers or points are provided for non-industrial firms, however, and cover four additional types of social organizations: Religious management, University, Hospital, and Institutional management. The number of total possible points in each case is 10,000. For comparison, two additional non-industrial categories are as follows:

⁴¹Jackson Martindell, The Scientific Appraisal of Management (New York: Harper and Brothers, 1950), p. 272.

<u>Religious Management</u>		<u>University</u>	
Social Function	1,000	Academic Function	1,000
Organizational Structure	800	Corporate Structure	800
Facilities Growth	500	Health of Growth	500
Membership Analysis	1,300	Development Progress	800
Development Program	800	Alumni Analysis	1,300
Fiscal Policies	800	Fiscal Policies	800
Trustee Analysis	800	Operating Efficiency	700
Operating Efficiency	700	Trustee Analysis	800
Administrative		Administrative	
Evaluation	1,200	Evaluation	1,200
Effectiveness of		Adademic	
Leadership	2,100	Leadership	2,100
	<u>10,000</u>		<u>10,000</u>

The respective points assigned, and even the inclusion of certain of these categories would probably be sharply criticized by many thoughtful persons.

Each year a Manual of Excellent Managements is published by the Institute, showing progress by individual firms in each of the ten categories that constitute management's responsibilities as seen by the American Institute of Management. The Fifth Edition⁴² interestingly enough includes General Electric as one of the ten outstanding companies, this of course being prior to the unpleasant publicity about violation of federal laws which led at least some of the managers judged superior to extended prison terms. This Fifth Edition lists alphabetically 492 excellently managed companies, including Chrysler, but excluding Ford. Significantly, two years later the list of excellently managed

⁴²American Institute of Management, Manual of Excellent Managements (5th ed.; New York: American Institute of Management, 1959), p. 35.

companies had grown to 537.

Representative questions from the 301 questions constituting the questionnaire which is used as a basis for the American Institute of Management audit are difficult to select because some are much more general than others, some are much more subjective than others, and some admit concise and precise answers although others require vague and non-comparable answers. For example, in appraising the Economic Function, these questions are asked among others: "What is the history of the acquisition of the fixed assets?" and, "Has the outlook of the Management always been well harmonized with social changes?" Even where questions can be answered objectively, the meaning of the answer must be interpreted. For example, under Fiscal Policies it is asked: "Are inventories on a LIFO basis?" and under Production Efficiency it is asked: "Are the company's plants unionized?"⁴³ Just what interpretation should be given to affirmative answers to the last two questions is a little puzzling.

Martindell and the American Institute of Management admit that distortions may occur in the eventual judgments because of personal bias on the part of the subject or the observer or both, but insist that lack of absolute certainty

⁴³ Martindell, Op. Cit., pp. 281-294.

does not render the "audit" impractical.⁴⁴

Other students of management (including this author) doubt the ability of the American Institute of Management under present circumstances to produce a meaningful, objective, and fair (rather than flattering) appraisal of management performance at top levels. The "procedures rest on unfirm ground," according to Koontz and O'Donnell.⁴⁵

The principles of management employed are improperly stated, terminological difficulties have not been solved, and scientific appraisal cannot be made until the rules employed by the institute for the subjective evaluation of the information acquired are made specific and public.

A complete audit program rather than a check list or questionnaire approach has been proposed, and includes these steps:⁴⁶

1. Review and discuss plans and objectives.
2. Appraise the organization structure in terms of functionalization, and departmentalization, and compare with the organization chart (if one exists).
3. Determine required action to improve effectiveness of policies and practices.
4. Determine company compliance with all levels of governmental regulations.
5. Examine systems and procedures.
6. Determine adequacy of controls.
7. Evaluate operations seeking to improve controls, communication, coordination, and efficiency.

⁴⁴American Institute of Management, Economic Function of the Corporation; Its Meaning--Its Evaluation (New York: American Institute of Management, 1953), p. 5.

⁴⁵Koontz and O'Donnell, Op. Cit., p. 698.

⁴⁶William P. Leonard, The Management Audit (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1962), pp. 82-83.

8. Appraise personnel requirements.
9. Examine plant layout and adequacy of physical equipment.
10. Incorporate suggested recommendations in a report.

It can be seen that, unlike the American Institute of Management audit, this type of audit is not intended so much to rate management in order to achieve accountability, as it is to share with management its problems in managing a complex organization. It is not intended to unearth and condemn incompetence so much as to alert management to more effective administrative procedures. To the extent that it is able to do that, it serves a useful function.

There is pretty general agreement that the challenge to the top executive is infinitely baffling, his work is creative, and his duties defy precise description. In decision-making he is expected to operate within a broad unstructured field of activity, giving him wide latitude, and margin for inventiveness. Some progress indeed has been made in mathematical applications to recurring problems, and in heuristic non-numerical techniques which promise to help make some middle-management problems semi-automatic, but these show little promise for top management use.

The development of control techniques, so deplored by the human relations people, has not served to render top-management more accountable to the owners (except to the extent that controlling the activities of their subordinates demonstrates management's own effectiveness) even though it

does enable top management to coordinate, plan and review the activities of a far larger group of people than previously could be subject to centralization.

Standards have been sufficiently well enough developed to permit fairly productive use in measuring performance of middle-management executives responsible for separate functions of organizational activity. The management audit can be useful to that extent. Application, however, of these standards to top management does not seem feasible because the demands of such positions are too ill-defined and broad in scope. Thus the management audit, although of some use in appraising executive performance at lower levels, falls short of permitting appraisal of overall management performance in a way which would permit stockholders to judge how well their officers were performing.

Certified Public Accountants should not accept present standards as adequate in rendering an objective opinion as to the overall effectiveness of management performance to be included in an audit report which would be relied upon by third parties; in the opinion of this author management audits now being issued by others cannot meet the tests of objectivity professional men require.

Recently, however, extended audit procedures have been developed by accountants in industry, in Federal government service, and in Scandinavian countries which stop short of

the management audit, yet seem to suggest measures which could be developed into procedures by means of which management accountability could be greatly increased.

CHAPTER IV
CURRENT APPLICATIONS OF EXTENDED
AUDIT PROCEDURES

The independent financial audit as performed by CPA's does not now regularly include any extensive examination of non-financial aspects, but audits of greatly increased scope, which attempt to measure the performance of management or of organizational functions, are actually presently being performed by accountants.

I. OPERATIONS AUDITING

The concept of operations auditing by internal auditors is a relatively new development, although the services of the internal auditor have been used for many years. He has long been considered a link in the chain of internal control, and the activities of the internal auditor have been relied upon by Certified Public Accountants in the preparation of opinion statements. The public accountant is necessarily interested in correcting any errors that are discovered and in the end results (i.e. the published financial statements). On the other hand, the internal auditor has frequently been directed by his superiors to assess operating controls or even make a critical evaluation of

operating functions themselves, either of which might be called an operations audit.

In 1957 the Institute of Internal Auditors published a supplement to the September issue of The Internal Auditor, entitled a Statement of the Responsibilities of the Internal Auditor, which expressed a much broader concept of internal auditing than did a previous statement which had been published in 1947.

The first two sections of the 1957 Statement of Responsibilities are as follows:

NATURE OF INTERNAL AUDITING

Internal auditing is an independent appraisal activity within an organization for the review of accounting, financial and other operations as a basis for service to management. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls.

OBJECTIVE AND SCOPE OF INTERNAL AUDITING

The over-all objective of internal auditing is to assist all members of management in the effective discharge of their responsibilities, by furnishing them with objective analyses, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor therefore should be concerned with any phase of business activity wherein he can be of service to management. The attainment of this over-all objective of service to management should involve such activities as:

- Reviewing and appraising the soundness, adequacy and application of accounting, financial and operating controls.
- Ascertaining the extent of compliance with established policies, plans, and procedures.
- Ascertaining the extent to which company assets are accounted for, and safeguarded from losses of all kinds.

- Ascertaining the reliability of accounting and other data developed within the organization.
- Appraising the quality of performance in carrying out assigned responsibilities.

It is clearly intended by the Statement that the operational audit begins where the financial audit ends. The scope of audit is simply extended into operating areas where the auditor can use his skills and resourcefulness in reviewing and assessing the effectiveness of operating controls, or perhaps even the operating functions themselves, in the same way that he has learned to do with financial controls. It is not some peculiar type of auditing which is sharply different and entirely unrelated, but rather instead an application of regular techniques and abilities in analyses extended to wider areas which include operations.

In financial audits, scrutiny is made of accounting policies and procedures, the chart of accounts, the system of internal control, and the accounting records and financial reports to determine the adequacy and effectiveness of the controls in providing a proper accounting of company affairs through management.

The types of control examined under the concept of the operational audit would be much more extensive and would also include those established by management covering organizational controls, manufacturing procedures, systems and methods, schedules, standards, budgets, operating records and reports. These controls would be considered in terms of

management's objective or plan of operation to determine whether they were adequate and effective.

The enlargement of the scope of internal auditing to include the audit of operations involves acceptance of the concept that just as financial controls can be appraised, the controls established and administered by nonfinancial functions of a business are subject to appraisal in like manner. Disagreement persists, however, as to the exact form this extension of activity should take.

Interpretations of Internal Audit Appraisal

It is conceived by some that the word "appraisal" used in the Statement of the Responsibilities of the Internal Auditor should apply only to the internal controls of non-financial departments of the business rather than to extending the appraisal by the internal auditor to the function itself. Certainly principles of control are the same regardless of the function to which the controls are being applied, as was pointed out in Chapter III, and the technical competency of internal auditors in appraising the effectiveness of internal controls could be used in all other functional areas as well as in the area of financial controls. It is, of course, true that the evaluation of controls cannot be effected without some evaluation of operations as well, but this concept assumes that such evaluation would be incidental to the major area of examination.

Considerable support for this somewhat limited concept of "appraisal" seems to exist, and it does seem likely that more cooperation would be available from personnel being audited at all levels in the organization chart and across every phase of operations so long as the internal auditor's review is limited to controls. As a matter of fact, any operating executive who is helped to control his operations should be quite cordial--in contrast to a situation where the internal auditor might be charged with the responsibility of evaluating the efficiency and effectiveness of operating functions.

It should be obvious that an auditor would not be expected to appraise technical skills of engineers, machinists, geologists, or any other specialist. His only real proficiency is in the area of appraisal of the way in which the activity or operation is administered: whether definition of objectives and their conformity to sound business principles has been made and communicated to interested parties; whether these policies conform to overall objectives; whether specific procedures are provided to implement them and are followed; whether orderly methods are used for the accumulation of necessary administrative information; and whether adequate reports (timely prepared) are furnished to management in regard to these.

It could, of course, be argued equally as effectively that the use of the word "appraisal" in The Statement of the

Responsibilities of the Internal Auditor means that functions themselves can be audited by the internal auditor, providing only that he is competent to make such an appraisal.

Those who accept this concept¹ want operational internal auditing to work through the organizational chart, functional statements, and procedural directives as well as the financial statements and books of account. A review of the organizational structure itself would serve to evaluate its effectiveness as a device for management control, and assure the most advantageous employment of the resources available. A review of planning and programming would determine whether these activities were consistent with approved overall master plans. A review of budgeting would determine not only the accuracy of computations in the budget but also assure that the intent of overall policies regarding production and future development were complied with. An examination of the control and application of funds would determine how effectively the funds available were being administered.

An examination of research and development would serve to determine how promptly and accurately laboratory developments were being applied in actual production. Examination

¹e.g., James A. Robbins, "Operational Auditing," Proceedings of the Twenty-Fourth Annual Institute on Accounting (Columbus, Ohio: The Ohio State University, 1962), p. 50.

of the procurement function would establish the adequacy of control over funds for purchasing, the reliability of the records and reports, the effectiveness and timeliness of negotiations, and the effectiveness of processing itself which would include inspection procedures, and the control and causes of re-work and revisions beyond a reasonable minimum. Examinations made of stock control can be envisioned, including scrutiny of the accuracy of computation of reserves, and the control procedures applicable to stocks, records, and reporting forms in connection with the accuracy of recording inventories.

Grave questions as to the technical competency of internal audit staffs inevitably arise if this broader view of the role of internal auditing is taken. This is especially true when it is recalled that the word "appraise" can be defined to mean "to estimate the value of." Such an estimation of many non-financial details obviously can only be made by an expert or a specialist in some field other than accounting. As an employee, however, professional competence and independence are not of the same overriding importance that they would be in the performance of the same type of functions by independent Certified Public Accountants. Management, of course, itself should define the general area of responsibility, and indicate whether the internal auditor's activities are to be limited to appraisal of controls of financial and accounting matters, whether they should extend

to the evaluation and measurement of other management controls, or should be extended to the appraisal of functions themselves. Certainly internal auditing cannot claim to have professional status unless professional auditing standards which are similar to the standards of independent accountants in reviewing financial accounting data are followed.

Special Techniques of Internal Auditing

The standards inevitably will be somewhat different, however, and some deviation from normal financial audit procedures will be found necessary. For example, although the use of records forms the basis for the beginning of almost any examination, instead of dealing solely with dollars, the internal auditor will find that he must deal more extensively with quantities, time, percentages of completion, or other symbols of work activity, which can be audited in the same way as monetary data.

Working with and reporting to management will also require the use of the appraisals, perspectives, and tolerances of management, rather than the more precise yardsticks of the accounting entry. Maintenance of the same precision which is typical in dollar accounting might be entirely out of proportion as far as cost is concerned in some operating figures. In other words, judgment rather than rigidity is essential.²

²Arthur H. Kent, "The Development and Application of

Regardless of the extent of examination considered appropriate in theory, however, the tendency of the enterprising internal auditor is to keep pushing the frontiers of his examination back farther all the time. The so-called operational audit developed because management felt the need for using the auditors' techniques in verifying the adequacy of controls in areas beyond those strictly of an accounting and financial nature. In management's activity of decision-making and control, it is obviously helpful for management to know that the controls that have been established are functioning. Assurance that that is the case does not, however, assure management that the decisions it has made are being executed, because it has no way of judging the effectiveness of the controls themselves. Management, then, would (if farsighted) obviously be quite eager to find competent personnel who would be willing to make appraisals of the functions themselves, which would include not only assurance that established policies and controls were being conformed to, but would estimate the overall efficiency of the department as well.

Here it is that the same difficulty is found in operational auditing as is found in the problem of overall measurement of management. In making an appraisal of the

a New Concept of Internal Auditing," The Internal Auditor, Vol. 14, No. 1 (March, 1957), pp. 10-11.

effectiveness of a department function the internal auditor would make certain first that he had accumulated a sufficiency of background information as to the nature of the activity he is to report on as well as its problems. The problem of evidence is a difficult one and he must make certain that he has complete evidence rather than incomplete or sketchy evidence so that all factors (whether good or bad) pertaining to this situation will be considered. The reviewing and weighing of the facts accumulated then must be done on a judicial or unbiased basis and essentially his decision as to the overall efficiency results from measuring his findings against prescribed standards.³

It has been seen that the development of standards of performance is a very difficult procedure, and that goals or yardsticks must be identified. Since these are usually unwritten, and frequently not even verbalized to any extent, identification of goals is frequently a formidable task for the internal auditor.

If standards applicable to a particular decision area can be agreed upon the internal auditor then can, as has been pointed out previously, attempt to ascertain whether the standards are consistent with the policies, plans, and procedures established by top management, whether they are

³Arthur H. Kent, "Internal Auditing is an Appraisal Activity," The Internal Auditor, Vol. 16, No. 3 (September, 1959), p. 38.

realistic in terms of possible performance, whether they are expressed in units commonly used to measure actual accomplishments, and whether the standard is being used to keep the accomplishments in line with the planned results.

Since the goal of internal auditing is to help improve managerial control, the lack of precision in measurement (discussed in Chapter III) does not disqualify the internal auditor from performing an operational audit. The measurement and evaluation of the effectiveness of other elements of control and even the evaluation of the performance of functions and departments (though lacking precision) is of value to top management, which must make evaluations anyway by some means. Operational audit reports are made only to line executives, and there is no question of liability to third parties.⁴

There are certain fundamental areas which management assumes to have been investigated by the internal auditor. He is expected to have verified the accuracy of reports and records, and there certainly can be no relaxation in this phase of auditing, both because it is essential to top management and its control of assets, and because of dual responsibility in connection with Certified Public Accountants and their independent audits. Failures on the part of employees to follow company policies are of interest to

⁴Max A. Kenyon, "Managers Want More Help," The Internal Auditor, Vol. 14, No. 2 (June, 1957), pp. 47-49.

managers, and the reason for failure to follow established procedures is of equal importance for they may indicate that the procedures themselves are ineffective. Top management should be vitally interested in discovering any practices that produce unfavorable public relations with employees, the public, or the industry. Obviously suggestions tending to reduce costs or eliminate unnecessary losses are hoped for, and opportunities for improper or dishonest transactions that are seen as organizational lapses are expected to be reported also. Any indication of duplication or omission of work or overlapping is sought by top management, also, and expected to be included in internal audit reports. In many cases top management relies upon the eyes and ears of its internal auditors in reporting details and evidence supporting a decision concerning the quality of judgment by local management. This in effect becomes a true management audit because the internal auditor reports back to his superiors something more than the accuracy of the reported profit; he is expected to indicate as well his opinion of the overall performance of an operation which may never be visited by top management personally.

Admittedly at this level of internal audit activity much of the report must be somewhat subjective, and thus results from decision-making activity. At the very least it can be seen as containing the usual bias which subordinates always pass on to their superiors.

Improvement of Future Business Operations

It must be pointed out, however, that the internal audit activity which attempts to report conformity to accounting and other operating controls is aimed primarily at assuring top management of the execution of its plans and policies. Where operational auditing is extended to the point that appraisal of an entire function or branch operation is made, the object is not so much perhaps to assure accountability as to be sure that management reviews and is able to take action on matters that will serve to improve future business operations. At the levels below top management, accountability is a less complex problem and can be assured if it is established that the person to whom responsibility has been issued is following directions.

Perhaps the true benefit of the operational audit, instead of establishing accountability as would be done if such an audit could be made of top management, is the way in which it may contribute to the improvement of future business operations.

In fact, rigid controls and the degree of adherence to them may have little place in modern business. Much of the difficulty in establishing a workable system of control really lies in the tendency to regard it primarily as a matter of directing activity from above in order that compliance by lower management levels assures the effectiveness of controls. Actually, in a progressive organization,

control may more properly be seen as a matter of "setting guide lines to achieve jointly agreed-upon ends," so audit activity accordingly might appropriately get into the planning phases of operations in order that the goals or objectives themselves may become the means for appraising both past results and guiding the direction of future action.⁵

If the extension of operational audit activity is seen as a two-way street to improve future operations, slightly different emphasis should be given to the auditing of particular departments or functions. Heavy emphasis should be given to a review of personnel, for example, with a view towards determining the adequacy of the work force, the turnover experience, the problem of overtime and the question of the work load itself in terms of the present volume of work. Certainly questions such as how an increase in work load could be handled and what would be the effect of a decrease are important. Productivity also, although difficult to measure, is of significance in terms of the increase or decrease of productivity per man hour, per letter written, or per purchase order issued. Whether or not productivity can be increased without undue increase in cost, of course, is an important question.

⁵William Travers Jerome, III, "Management Control--Some Audit Implications," The Internal Auditor, Vol. 14, No. 3 (September, 1957), pp. 43-44.

Quality, although a subjective matter, presents a problem for the internal auditor, but some activities which are routine in the financial audit may be of help here. For example, the amount of scrap, the number of errors made, the number of customer complaints, or the number of employee grievances, are all indications of the quality of work.

The number and nature and extent of reports which are sent to departments and from departments could be reviewed, together with costs and expenses. Here the internal auditor is returning to the fold of financial auditing, but must approach it from the management viewpoint instead. Not only is he concerned as to the correctness in amount of cost and expenses, but must instead ask rather whether the amount is justified. Trends are important in determining whether the direction is appropriate in keeping with the productivity of the department, and the question of whether the amount is justified in terms of the company's overall objectives and in terms of the role of this particular department is important. Decisions as to whether to make or buy, and to lease or buy, as well as comparison of actual costs and expenses with forecasts, budgets, and standards, could be investigated together with material deviations from any controls.

In a sense, internal auditing (having developed into a consideration of the means of improvement of future business operations) might well ask something like this: "Can

this be done better, at less cost, and still meet the objectives of management?" The purpose of the whole audit might appropriately be found in the answer to this question.⁶

It can be seen that the problem the internal auditor faces as he moves into performance audits is not dissimilar from the measurement difficulties expressed in Chapter III. He possesses certain advantages, however, that are not possessed by someone who would be independent of the organization, and whose report would be relied upon by third parties. It is certainly true that there has not yet been established any thoroughly objective way in which standards can be established, and in which such subjective questions as effectiveness of personnel activities, and the quality of production, etc., can be answered. Standards again pose a very difficult problem.

It must be remembered, however, that the internal auditor as he begins his operations audit is frequently charged simply with the task of using his eyes and ears as a partner of management, and his report, after clearance with the individuals involved, is intended for the eyes and ears of management alone. Top management has the right, in the absence of ability to observe personally the workings of a distant division, to dispatch some responsible group

⁶Robert E. Seiler, "The Operational Audit--An Extension of Management Controls," The Internal Auditor, Vol. 16, No. 1 (March, 1959), pp. 13-14.

of men who are charged with the responsibility of returning and telling what they see. Since the internal auditor is well able to perform his traditional function of assisting the independent accountant with his review of internal control, he would be able as a result of his training and experience to extend the same techniques to other controls in operating departments, and he can describe to top management his impressions of overall operating efficiency, in very much the same way that subordinates always bring alternatives to their superiors with a built-in bias.

On the whole, the extended audit procedures used by internal auditors seem to be performing a worthwhile function. The problems which rule out a management audit at the top level, although a source of difficulty in the performance audit of a division or department, are not significant enough to restrict the effectiveness of the performance audit by internal auditors. This application of extended audit procedures offers interesting possibilities of modification in such a way as to increase top management accountability to owners.

II. POLICY AUDITS OF THE GAO

The policy audits of the General Accounting Office (frequently called procedural audits) seem to represent an extension of the philosophy which has spurred the internal auditor to assume responsibility for examination of controls

outside those of a financial or accounting nature. The development of internal auditing within governmental agencies seems to have taken approximately the same course as has developed within private industry. Internal auditing is seen as an element of management control, in that it reviews, appraises, and reports to management upon the effectiveness of controls. In large part, apparently, the internal auditor working for an agency of the Federal Government finds that his responsibilities have extended beyond examination of accounting and financial controls into the area of review of operating matters, with a view toward supplying responsible parties with information as to whether operations are being carried out effectively, efficiently, and economically. The government internal auditor is an assistant to management, also, rather than exercising the managing, supervising, or directing function. Government agencies for the most part have found their administrative problems to be as numerous and complex as those in business, and top administrators find themselves formulating overall policies and procedures, attempting to see that they are executed, and reviewing reports concerning their performance. Internal auditing then, like in industry, is the means by which agency administration keeps itself informed as to what is going on at the point of operation, learns of problems at the point of occurrence in order that remedial measures may

be taken promptly, and points out opportunities for savings, increased efficiency, and better ways of doing things.⁷

If changing concepts regarding internal auditing are responsible for the development of the GAO procedural audit, it is apparent that distinctions between the GAO audits and the reports issued by Certified Public Accountants should exist. The major objective of the audit examination of a Certified Public Accountant must be the production of the auditor's report, regrettable though that may be. Since this report includes financial statements purporting to show the results of operation and the financial condition of a firm as of a particular time, audit procedures are tailored to emphasize the accuracy of the information to be included in the report. It follows, therefore, that any evaluation as to the adequacy and effectiveness of operating procedures is somewhat of a by-product, depending upon the client's interest in such information. Even then, possibly such activity would not be considered an appropriate part of regular audit activity, but might well be assigned as a responsibility of the Management Services division of the public accounting firm. The financial audit report currently being issued is intended primarily for the use of outside parties (probably more for creditors and potential

⁷U. S. General Accounting Office, Internal Auditing (Washington, D. C.: United States General Accounting Office, 1957), pp. 2-3.

investors than for present stockholders) rather than for the use of those officials who have responsibility for the day-to-day operation and management of the firm.

Nature of Procedural Audits

The GAO policy or procedural audit on the other hand has an entirely different set of audit objectives. Kohler⁸ emphasizes that whereas the primary purpose of the public accountant is to "obtain sufficient evidence upon which to base an opinion of the propriety of the financial statements," the basic aim in a GAO audit, on the other hand, is to determine how well an agency being examined "has discharged its financial responsibilities." The major objective of a procedural audit is seen then as an evaluation of the adequacy and effectiveness of operating procedures, and is intended as an aid to those who are responsible in the operation and management of the activity, although the information found is usually sent on to superiors in order to establish accountability.

It seems safe to say that there is less distinction as to fundamental accounting principles and standards of audit examination between the financial audit and procedural audits than would at first appear. After all, the balances of the books of record and the reports issued, even when the

⁸Eric L. Kohler and Howard W. Wright, Accounting in the Federal Government (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1956), p. 74.

audit activity is limited to financial audit, are the result of operating as well as accounting procedures. The procedures and results of procedures are entirely too closely related to support a sharp distinction between operations and accounting in examination of these activities. Certainly since the auditor involved in a procedural audit is expected to include recommendations when he has concluded as to needed improvement, a factual basis is required in order that management need not be forced to draw its own conclusions from an auditor's inference, but may rely upon complete factual reporting of the nature of a deficiency or inadequacy.

Fundamental audit techniques and procedures are common to both types of audit, although the degree to which these are applied varies because of the different objectives. For example, precise dollar adjustments must be considered by the auditor in a financial audit before the completion of the audit report. The cause for the adjustment is not a matter of great concern, or perhaps not of any concern. On the other hand, the nature and implications of deficiencies found in a procedural examination are of paramount importance, even though the dollar effect of the deficiencies need not be stated with the same precision that is required before an adjustment can be made in a financial audit. If the deficiency can be described as to its nature and significance, precise measurement of value either in dollars or units is not nearly so important. Frequently, of course, estimates

by dollars or units are given to show the auditor's opinion of materiality, but since evaluation of the economy, efficiency, and effectiveness with which the financial responsibilities of an agency have been discharged is the major goal of the audit, precise dollar measure (so important in showing the financial condition of the firm) does not present the problem in measurement, that these somewhat judgmental or qualitative activities would seem to present.

The Responsibilities of the General Accounting Office

Although the General Accounting Office was established by the Budget and Accounting Act of 1921, the GAO has modified and modernized its audit techniques considerably within the last 15 years. As a result of the Acts of 1945 and 1950 the existing audit authority of the GAO which was transferred from the Treasury Department by the 1921 Act has been clarified and impetus has been given to the modern techniques that characterize GAO audits today. The Comptroller-General is recognized as an agent of the Congress and is directed through his audit activity to determine the extent to which accounting and related financial reporting provide full disclosure, adequate financial information needed to manage operations in execution of the budget, and effective control over receipt and disbursement of all assets. The extent to which financial transactions have been made in accordance with legal requirements and

regulations, the exercise of adequate financial control over operations, and determination of an effective basis for the settlement of account of accountable officers are also provided for.⁹

The general audit objectives as established by the GAO itself include examination into the following matters:

1. Whether an agency is conducting the activities or programs authorized by Congress in the manner contemplated, and only such authorized activities. Where applicable, review is made to determine whether the programs or activities authorized continue to serve effectively their original purpose.
2. Whether effective, efficient, and economical conduct of programs and activities are made in compliance with legal regulations, and directives by the Comptroller-General.
3. Whether funds, property, and personnel are being utilized and controlled in an effective, efficient, and economical manner.
4. Whether receipts arising from operations are properly accounted for.
5. Whether the accounting system of the agency complies with prescribed principles, standards, and other requirements of the Comptroller-General

⁹Joseph Campbell, Annual Report of the Comptroller General of the United States for the Fiscal Year Ended June 30, 1961 (Washington, D. C.: United States General Accounting Office, 1961), pp. 5-6.

6. Whether agency reports to the Congress or other control agencies are accurate.

As in any audit activity, information is gathered, evaluations are made, and recommendations where appropriate are developed. Certain broad phases of work have become standard operating procedures with GAO.

The preliminary survey consists of obtaining information as a general basis for planning the audit program. Many preliminary surveys, of course, do not develop into complete audits. Factors considered by General Accounting Office personnel include the degree of congressional interest, the potential dollar amount of discrepancies that could be discovered, the extent and importance of potential adverse findings, and sometimes specimen continuing programs are selected solely for the purpose of setting standards which can be applied to other agencies.

Staff members emphasize that the preliminary survey is meant to be very brief. When written up for review it serves as a basis for determining whether further auditing steps are required. It is an information-getting activity, but no standard check list is used. One reason may be some concern that a check list might tend to encourage spending too much time on information-finding and not enough on analysis. During the course of the preliminary survey the auditor may frequently find agency personnel expressing their own apprehension as to certain matters. Hearings of

congressional committees are drawn upon, also, and surveys engaged by the agency administrators are scrutinized. The extent of internal audit, of course, is relied upon, and action on audit findings is reviewed in the same way as by the public accountant. Specifically such information as the following would be included:

1. Laws applicable
2. History, etc.
3. Organization
4. Nature, location, investment, and assets
5. Other financial data
6. General policies
7. Operational methods
8. Unsolved problems
9. Areas of special information of interest to Congress

Personnel emphasize that the GAO is not engaged in second-guessing, nor do they take advantage of 20-20 hindsight. The auditor is expected to put himself in the same position as management, and not to pounce upon general information which was unavailable at the time the decision was made as evidence of a lack of efficiency, effectiveness, or economy.

If it is decided to go beyond the preliminary survey a review of legislation next takes place, in which legislative history is studied to ascertain congressional intent as to the purpose, scope, and objectives of agency activities being examined, the manner in which activities are to be conducted and financed, and the nature and extent of the authority and responsibility of the agency and management.

The next step is the review and testing of management controls. First a preliminary review of controls is made to obtain sufficient practical information to permit general appraisal of the adequacy and effectiveness of performance, to identify possible weaknesses having sufficient significance to warrant more detailed examination, etc. If a detailed examination appears warranted, additional attention is given to such matters as these:

1. Adherence to prescribed policies
2. Accomplishment of intended purposes of activities conducted
3. Operational efficiency
4. Efficient and economical utilization of property and personnel
5. Effective control over expenditures, receipts, revenues, and assets
6. Proper accounting for resources and financial transactions
7. The production and reporting of accurate, reliable, and useful financial data
8. Compliance with requirements of applicable laws, regulations, and decisions.

The development of findings occurs next, which includes the exploration and development of all data considered pertinent and significant in order that proper consideration and support may be given to the presentation of any findings, conclusions, and recommendations to be incorporated in the audit report.

GAO field men are cautioned that the government agency itself has the primary responsibility to determine the manner in which it will operate. No direct changes in agency policies can be made by GAO auditors, even though they do

observe what they consider to be opportunities for achieving greater economy, efficiency, and effectiveness.¹⁰

Accomplishments of the GAO

General Accounting Office procedural audits emphasize the necessity of accountability to superiors; the accountability of the GAO itself to its superior, the Congress, is not subject to any standard tests of measurement, but relies instead upon the magnitude of savings which it can claim through its exposure of inefficiency, ineffectiveness, or waste. Mr. Joseph Campbell, the Comptroller-General of the United States, submitted a report March 23, 1962 covering the activities of the General Accounting Office for the fiscal year 1961, in which he points out that collections of nearly \$38,000,000 were made during the year through the efforts of the GAO. In addition, actions were taken by other departments and agencies during the same period of time as a result of findings and recommendations and these are asserted to have resulted in either definite, measurable savings or at least possible savings of well over an additional \$95,000,000. Of this amount nearly half, (\$45,000,000) resulted from cancellation of requisitions for materials and supplies not required by countries under the Foreign Aid Military Assistance program. For purposes of this study,

¹⁰U. S. General Accounting Office, Purposes and Objectives of Independent Audits by the General Accounting Office (Washington, D. C.: United States General Accounting Office, 1961), pp. 4-10.

however, the types and varieties of recommendations are of greater interest. Some examples follow.

It was found that certain government land, restricted to mining uses, was actually used for summer homes, permanent residences, town sites, orchards, commercial enterprises and farming, and even a house of prostitution.

The General Services Administration (GSA) was found to be spending \$1,000,000 annually grading certain metals that already had been graded by manufacturers.

The government lost an estimated \$12,000,000 to \$15,000,000 from the sale of cotton by about 700 cotton brokers to themselves before it was later resold to the government at a neat profit.

\$25,000 was budgeted for an airfield for some army officers at Fort Lee, Virginia, who managed to spend over a half-million dollars before congressional wrath resulted from a GAO audit.

The activities of the General Accounting Office provide such a rich variety of material that it is difficult to generalize about audit reports submitted. Some audit reports are strictly financial statement audits in the traditional sense. For example, the report to the Congress of the United States on the Audit of the St. Lawrence Seaway Development Corporation for the period July 1, 1959 through December 31, 1960 indicates in its letter of transmittal:

The principle findings of our audit relate to the (1) unauthorized exclusion of depreciation cost of Seaway facilities from the toll base consisting of all cost and amortization of the corporation's debt within a 50-year period. (Costs are required by law to be recovered through tolls "as nearly as practicable"), (2) discontinuance of the policy of accounting for depreciation of Seaway facilities and (3) unsatisfactory financial statements prepared by the corporation which, in our opinion, are misleading and do not provide a full, fair, and clear presentation of its financial position as a result of operations.¹¹

In this case the corporation officials insisted that depreciation does not fit into the financing plan of the corporation which is to pay the out-of-pocket costs, replace assets with lives of less than 50 years and amortize the debt itself together with interest within 50 years. They contend that many of the assets such as ship channels and lands are non-depreciable and that the other assets have an estimated useful life of more than 50 years so that the cost of the Seaway cannot be recovered within the 50 year statutory period if depreciation accounting is used. Consequently they believe that amortization of the debt must permit recovery of the cost of the major facilities within a much shorter period than the estimated useful lives of the facilities. The GAO takes exception to that position because they insist that the corporation's accounts and financial statements must disclose the extent to which revenues are

¹¹These audit reports to the Congress are addressed to the Congress, but a copy is submitted to the President and they are publicly distributed as well.

recovering costs as usually computed, and intended by the Congress to be recovered "as nearly as practical."¹²

Many interesting examples, on the other hand, of a "management" type or procedural audit could be cited, but the Report to the Congress of the United States, Review of Selected Activities of the Federal-Aid Highway Program in the State of Idaho, Bureau of Public Roads, Department of Commerce, is typical. The Seaway report was delivered to the Congress in January of 1962, and the Federal-Aid Highway Program Report was delivered in October of 1962. The GAO auditors took exception in the latter report to several items which have financial implications, but which are beyond the scope ordinarily observed in a regular financial examination. They complained that substantial costs were sustained in excess of those that would have been required had the standards suggested by the Bureau of Public Roads been followed in regard to not building expensive overpass roads for highways with average daily traffic of less than 10 vehicles and then constructing them with load capacities and widths substantially in excess of the amounts warranted by the traffic. They also objected to the arrangement whereby highway contractors must include Idaho State motor fuel taxes in their bid prices and return refunds on such

¹²Comptroller General of the United States, Report to the Congress of the United States, Audit of Saint Lawrence Seaway Development Corporation for the Period July 1, 1959 through December 31, 1960 (Washington, D. C.: The General Accounting Office, 1962), pp. 13-14.

taxes to the state. Since the contractors have no incentive to claim the refunds they have not done so and the state therefore retains the funds collected in the form of motor fuel taxes, total costs are increased, and there is a resultant increase in the proportion of costs to be born by the federal government.

Objection was voiced as well to certain inconsistencies and inadequacies in both the Bureau's and State's inspection and testing procedures and policies. These are intended to provide assurance that the contractor is meeting contract specifications, but it was noted that testing practices relating to roadway embankment were not consistently followed, and that although specifications for asphalt materials did not meet the standards or tests prescribed, the apparently defective material was used anyway. In this instance, GAO criticism suggested that the Bureau was expecting the State to be responsible, whereas the Bureau has responsibility for review and control in order to assure performance so that the completed work will be durable and of high quality. It should be noted here that there is in no instance an attempt to impose technical or profession standards relating to some operating activity, but there is rather simply a common sense insistence that professional standards established by qualified personnel have not in fact been followed.

It should further be noted that the GAO does not object to any profits as such, and would not take exception in an audit report to the amount of profit per se. What it would take exception to in a report is an instance where a company estimated lumber, for example, in a contract to be \$500,000, when in fact it turned out to cost only \$100,000, or in a case where a company includes a \$200,000 item in a contract for expert skills for a portion of the job when the skills were actually never used.

Are GAO auditors able to determine standards for evaluation of efficiency, effectiveness, and economy? Interesting replies are given when staff members of the General Accounting Office are asked about standards. One relatively highly placed staff member suggests that in effect "the proof of the pudding is in the eating," and asserts that the results of GAO activities justify continuation of the program, and that concern over developing rigid standards is not of crucial importance. As he puts it, "Perhaps rigid, universally applicable standards are not as important after all, as coming up with something worthwhile as to findings and recommendations." It is generally agreed seemingly by staff members that it may be well-nigh impossible, if not entirely impossible, to prescribe standards for measuring and reporting on total operations of a business firm. There is general insistence, however, that standards can be established on an agency basis (or for a division?) for plans, procedures, and

controls. It was suggested that the GAO has not been adverse to recommending changes in the goal itself--which in the case of a federal agency would involve a change of the law.

The Rationale of the Policy Audit

Ellsworth H. Morse, Director of the Accounting and Auditing Policy staff of the United States General Accounting Office suggests¹³ that there are general standards which can be used in judging management performance in terms of effectiveness, efficiency, and economy. For many types of operations the management itself, however, will have provided techniques for evaluating performance or at least comparing performance with predetermined objectives. In such a case, of course, the independent auditor may question the validity of such standards and their usefulness. Lacking specific measures established internally, the job of appraisal is much more difficult because the methods of examination and evaluation must be developed by the auditor himself, using all available factual material, and recognizing that his opinions, conclusions, and recommendations must be supportable.

An overriding consideration with the GAO audits, of course, is the consideration of the requirements of applicable laws, and the comprehensiveness of the independent

¹³Ellsworth H. Morse, Jr., "GAO Audits of Management Performance," The Journal of Accountancy, XCII, No. 4 (October, 1961), p. 44.

review depends in part upon the completeness of specific legal or policy declarations.

In questions regarding the proper utilization of resources such as personnel, for example, a great variety of specific laws and regulations relate to compensation, sick leave, attendance, classification, and rights and privileges--all of which in a sense may be considered standards against which actual performance can be checked.

Ordinary prudence and cost consciousness in the spending of other people's money can be considered as a factor in arriving at an independent judgment regarding potential waste or extravagance. Procedures that permit acquisition of goods and services far ahead of their need would be suspect, or evidence that inaccurate or unreliable information led to decisions to acquire excessive quantities, which present storage and handling problems as well as risk of deterioration.

It is recognized apparently that standards do have to be broader than would be required under a traditional audit because items other than those purely financial are involved, and inevitably the performance of people is being audited. The exercise of extreme care and the testing by exposure and rebuttal of tentative conclusions is emphasized as very important. Collection of adequate information in order that the reader may judge the soundness of the report, without having to rely either upon a categorical statement

by the auditor, or by reading between the lines, is also important.

There are really two fairly effective answers to criticism of lack of objective standards. In the first place, the General Accounting Office avoids using such phrases as "in our opinion." They are more apt to indicate: "Experience or previous standards show certain levels; why were not these used so that performance would be comparable to these previously established standards?" For that reason GAO auditors give a great deal of attention and care to the building up of carefully documented evidence showing the difference between standards which are available or which have been determined by technically qualified personnel, and the reasoning by which GAO staff members question the effectiveness, efficiency, and economy of performance of a particular agency.

Perhaps a more important answer, at least in terms of this paper, is the repeated suggestion that there is a difference in the nature of audit evidence which is considered acceptable. One staff member uses this example: If a Certified Public Accountant were to make a verification regarding the purchase of a parcel of land, he would ascertain whether or not there was an appraisal made before purchase. It is contended, however, that a General Accounting Office auditor would not stop with an appraisal, but would insist upon finding the basis for it. He would go so far

as to visit the court house to see if the appraisal price seemed justified in terms of what comparable land was then selling. In other words, expert indirect evidence is considered acceptable by the CPA; direct evidence is more sought after in a GAO audit. It may well be that the different approach to audit evidence is the most distinctive feature of General Accounting Office audits.

The experimentation of the General Accounting Office in extending audit techniques into areas which were previously thought not to be suitable for audit, is like a fresh wind blowing for the accounting profession. Engendered, apparently, by new developments in the field of internal auditing, where operations audits are being performed, the GAO has boldly moved to try to make audits more meaningful--particularly in the sense in which audits were originally conceived: the holding accountable of persons to whom responsibility for management of someone else's resources has been assigned.

It is relatively easy to criticize the approach taken by the GAO on grounds that standards have not yet been adequately developed, and that auditors are not in a position effectively to evaluate performance. Certainly on the basis of examination of a particular agency or organization or part of the organic whole, the standards that have been developed seem to be reasonably adequate, and the care which is taken by means of a slightly different approach to audit

evidence in building up a case for the statement of an opinion or recommendation should be of tremendous interest to all professional accountants and students of accounting.

It could be contended that the General Accounting Office is in a favored position in comparison with both internal auditors who owe their job to their superior, and the CPA (who although striving to be independent wishes to retain his audit engagement), because of the independent nature of GAO relationships to the Congress. It might also be assumed that the third party liability which is of such concern to the Certified Public Accountant is lacking so far as GAO auditors are concerned. Such is not at all the case, staff members are quick to contend. The General Accounting Office is not, by any means, the most popular agency in the federal government, and has many enemies. It relies for its budget upon the interest of the Congress in its reports, and GAO staff members feel that there have been many concerted attempts to throttle their independence, or eliminate the General Accounting Office and its functions entirely.

There is much in the policy or procedural audit of the General Accounting Office staff to commend the interest, study, and the experimentation of independent CPA's.

III. MANAGEMENT REVIEWS BY SCANDINAVIAN AUTHORIZED PUBLIC ACCOUNTANTS

At every International Accounting Congress since the 1938 Congress in Berlin (including the most recent one in New York in September, 1962), discussion has been elicited from Finnish and Swedish Authorized Public Accountants concerning the requirements of the Companies Acts of the two countries that comments be included in the audit report concerning management performance. The Eighth International Congress of Accountants in New York in September, 1962 was addressed by Mr. Ebbe Rybeck, who distributed copies in English of the 1961 annual report of a Swedish corporation, Aktiebolaget Separator. This published report begins with comments by the Managing Director in considerably greater detail than would be expected in reports published in this country. His report concludes with the financial statements, which are signed by all of the directors, and followed by this comment, "With reference to the Auditor's Report we have made, we certify that the above Profit and Loss Account and the Balance Sheet agree with the Company's books and accounts." This certificate is signed by three auditors, only one of whom, Mr. Rybeck himself, is an Authorized Public Accountant and auditor.

Distinctions Between Scandinavian and American Audit Reports

Two distinctions are quite evident thus far between Swedish and American financial reports: more prominent

attention is given to the Managing Director's detailed description of company activities, including specific items of the financial statements themselves, and that the several auditors, who are not necessarily related professionally, have only certified that the figures given by the Managing Director are in agreement with what is to be found on the Company's books.

This report by the Managing Director is followed, however, by the auditor's report, where the auditors appear to have, in effect, made a "management" audit in addition to the regular financial examination made in this country. The auditors' report for Aktiebolaget Separator, which follows, is typical of reports issued by Swedish and Finnish accountants, and is in conformity with the Companies Acts of the two countries:

In our capacity of auditors to Aktiebolaget Separator, we hereby submit the following report for the year 1961.

We have examined the Annual Report, studied the accounts, the minutes and other documents containing information as to the financial position and the management of the Corporation, and made such other inquiries as we considered necessary.

The detailed checking of the records has been carried out by the Corporation's internal audit department who have reported to us on their examination.

The provisions of the Corporation Act concerning shareholdings and group reporting have been complied with, yet with the limitation that a number of non-Swedish affiliated companies, as in the preceding years, have not been included in the Consolidated Balance Sheet now presented. We have, however,

received the necessary information concerning these affiliated companies.

In the course of the audit there appeared no reason for criticism to be made upon the Annual Report, the book-keeping or the verification of assets, or upon the management.

The Board of Directors and the Managing Director propose that the profits according to the Balance Sheet be appropriated as follows:

Dividend to shareholders	10 800 000
Carried forward	28 569 998
	<u>Kronor 39 369 998</u>

This proposal does not conflict with the provisions of the Corporation Act concerning appropriations to legal reserves or with sound business practice.

We recommend

that the Balance Sheet as at December 31, 1961, included in the Annual Report and signed by us, be adopted,

that the profits be appropriated as proposed above, and

that the Board of Directors and the Managing Director be granted discharge from liability for their management for the period covered by the Annual Report.

Stockholm, March 30, 1962.

EBBE RYBECK
Authorized Public
Accountant and Auditor

O. W. LINDSTROM

WILHELM MOBERG

The information included in this report is required to be sent to the Registration Authority, which makes copies available to the general public. The statutes of the two countries are quite rigorous in regards to the contents of these documents, which are supplemented by other special documents which are made available by the Managing Director to the auditors, to aid them in fulfilling their function.

Both the financial statements and the Managing Director's report contain considerable detailed material which is required by statute. It will be noticed that a proposal for distribution of the profit as to dividends and to increase retained earnings was included in the auditor's report of A B Separator. Since dividend declarations are approved at the stockholders meeting, the stockholders' equity before any distribution of the profit must be shown on the balance sheet. In the auditor's report which was quoted, the proposal by the Managing Director, as to the distribution of the profit, is stated as not being in conflict with the provisions of the Corporation Act concerning appropriations to legal reserves or with sound business practices, and is recommended by the auditors. A decision as to this proposal must be made within one month, and reported to the Registration Authority.

Provisions of the Corporation Acts

The Swedish Corporation Act spells out (in a total of 169 pages) the details of assuring accountability of the Managing Director to the stockholders. The exact order of balance sheet items is included in the Act, and specific provisions cover the treatment of individual items on the financial statements.

In addition to the financial statements, the Managing Director is expected to furnish information on any important matters in order that a true judgment may be made as to the

financial position and the results of operation of the corporation as well as of the management of the board.

As was noted in the discussion of the A B Separator report, the auditors must sign the balance sheet and profit and loss account in addition to presenting a separate audit report. The following items are to be included in the audit report itself, which is over and above the certificate that the statements are in accordance with the accounts of the corporation:

1. An account of the result of the auditor's examination.
2. A statement as to whether or not the auditors have any censure to make regarding
the annual report,
the corporation's bookkeeping,
the corporation's verification of its assets, or
the management of the corporation's affairs.
3. The causes for censure, if any.
4. A statement regarding the approval of the balance sheet.
5. A statement regarding discharge from liability of the members of the board and the managing director.
6. A statement as to the recommendation of the board and the managing director regarding the corporation's profit or loss, stating specifically whether or not this recommendation includes due appropriations to legal reserves.
7. A statement on the writing-up of fixed assets, if such has been done according to a special provision in the Act.
8. A statement on any current assets that are carried at a value higher than their acquisition or production cost, if such valuation appears in the balance sheet.
9. A statement regarding the examination of certain pension foundations.

In the case of a parent corporation certain additional items must also be included, as can be seen in the A B Separator report.

Records indicate that as early as 1652 Swedish and Finnish auditors, sometimes called assistants, delegates, deputies, or representatives, were appointed by owners of associations (roughly comparable to today's corporations) and charged with the responsibility of deciding whether the management should be granted discharge from responsibility for its administration.¹⁴ By 1800 the examinations of these representatives had been extended to include the administration of the board of directors as well as the financial records themselves, and it was considered by some that these representatives should act as advisors to the board of directors, offering constructive advice on their own initiative.¹⁵

The Corporation Act of 1895 provided that every limited company or corporation was required to have its accounts audited annually by one or more auditors, to be appointed at the regular shareholders meeting. Since, however, many companies, including even a number of large companies, felt

¹⁴Borje Forstrom, "Auditing the Management," The Accountant, May 24, 1958, pp. 620-621.

¹⁵Oskar Sillén, Om förvaltningsrevision i Svenska aktiebolag (Stockholm: Affarsekonomi, 1952). There is no English translation of this available, which is true also of two Finnish books by E. Usva (1937) and L. Cederberg (1938). A translation of significant portions of Professor Sillén's book was furnished to the author by a partner in the Stockholm office of Price Waterhouse & Co., and Professor Sillén's formal approval of the translation was obtained before being forwarded to this country. The Price Waterhouse representative in Helsinki reviewed the two Finnish books mentioned, and concluded that they did not cover any matters of interest

at that time no particular need for auditing services, it became fairly common to appoint persons with no particular qualifications for auditing work. The Swedish Corporation Act of 1944 which became effective on January 1, 1948, and was further amended in 1950, sought to establish standards of competency in order that the audit requirement might not be sidestepped.

To Americans, the question of competence of Swedish and Finnish accountants to render an opinion as to management's performance is of great interest. Considering that it had been possible for years for Scandinavian corporations to select auditors with negligible theoretical or practical qualifications, it must be granted that the improved standards since the establishment of Authorized Public Auditors in 1912 are of great significance. The current Swedish Stock Corporation Act in Section 107 certainly provides requirements as to qualifications which are sufficient to supplement the considerably more rigorous regulations governing the duties and the rights of auditors.

The auditor shall be of age and legally competent;
"an auditor shall have such experience of bookkeeping and knowledge of economic conditions as his appointment calls for with regard to the corporation's activities." For

beyond those covered by the translation of Professor Sillén's article. Page references to Professor Sillén's book are to the translation copy which was forwarded to this country by Price Waterhouse.

listed corporations, and in fact all larger corporations, at least one of the auditors shall be an Authorized Public Auditor. He may not be an employee of the corporation or be subordinate to or dependent upon board members, the Managing Director of the corporation, or anyone dealing with corporation accounts and funds or be directly related to any such persons (i.e. parents, children, brothers, sisters, or brothers-in-law).

Although references so far have been made to the Corporation Act of Sweden, the Corporation Act of Finland is comparable, having had the same origins. The same concurrent and parallel development has occurred with regard to the licensing of professional auditors. In both countries the auditor is certified by the Central Chamber of Commerce, which is authorized by the government for the purpose of promoting the economic life of the country.

In Finland, before the auditor can be certified, he must have passed the examinations of one of the four universities of economics (which require three years of full time study), he must have had experience in the closing of books, and must also have had experience in industry, particularly in administration. A special two-part examination is then given to him: one part of a theoretical nature requiring a proficiency roughly equivalent to what might be expected in the United States to qualify for a Master's degree in Economics, and the other covering practical matters

such as auditing, taxation, report writing, and ethics.¹⁶

Although in Finland apparently it is not unusual for persons to have had no auditing experience to sit for the examinations since the Central Chamber of Commerce attaches so much more importance to the practical experience of the applicant and his apparent ability to judge administration of the companies, in Sweden, on the other hand, there is no special examination required if the applicant has had five years of experience under the supervision of an APA.¹⁷ The requirements of both Swedish and Finnish universities probably are vastly different from requirements of American universities, since the University of Commerce in Stockholm, for example, is only able to accept about 200 out of 600 applicants annually for admission. Of these 200, only around one-fourth manage subsequently to pass their examination for a certificate enabling them to become Authorized Public Accountants.¹⁸

Regulations have been issued by the Chambers of Commerce governing the work of the APA. For example, he may not carry on any trading or agency business or be a partner in a business firm or a public official.

¹⁶Borje Forstrom, Proceedings of the Sixth International Congress of Accountants (London: Ginn and Co., 1952), pp. 466-467.

¹⁷Sven-Hakan Leffler, "The Accountant in Practice and in Public Service," Proceedings of the Sixth International Congress of Accountants (London: Ginn and Co., 1952), p. 441.

¹⁸Ibid., pp. 440-445.

Local chambers of commerce also issue certificates to another category of public accountants, who are called "approved accountants" in both countries. No university training is required for this designation and no special examination is required. Less demanding audits are performed by these "approved accountants," who usually have other employment in addition.

Recommendations As to the Management

The really unique feature of Swedish and Finnish audits is the legal requirement that the auditor must comment regarding management performance. The purpose, which has a long history in business activity of these two countries, is that the auditor may share with the shareholders his discovery of any administrative measures (such as, for example, danger of misguided capital transactions) that are of such nature and scope that the shareholders' opinion might conceivably be influenced regarding the matter of granting the board discharge from responsibility.¹⁹

Sillén²⁰ quotes from certain statements in the Report of the Swedish Company Law Committee on pages 446-449.

Auditors . . . have to insure that not only have the best interests of the company and the shareholders been properly observed but also that no violation has

¹⁹Olof I. Cassel, Proceedings of the Seventh International Congress of Accounts, 1957 (Amsterdam, Herengracht: 1957), p. 102.

²⁰Sillén, Op. Cit., pp. 8-9.

occurred of the regulations contained in the Company Law or in the company's own statutes which are intended to protect the interests of the creditors, other third parties, or the public.

Naturally, this management audit does not mean that the auditors have a right to influence the management. The examination is mainly intended to discover or prevent illegal or otherwise indefensible management actions. The auditor should not criticize the economic advisability of management decisions, except where the latter are of such a nature that they may lead to a refusal to grant discharge from responsibility, or where claims for damages, or otherwise, may arise from the violation or omission of duty by the management of the company. When judging management actions the auditors, of course, have to consider the circumstances prevailing at the time the actions were taken, and obviously the auditors should always use discretion in their examination of management.

This was phrased quaintly but well in New York during the Eighth International Congress in September of 1962 in a personal interview with Scandinavian accountants including Mr. Svente Kihlman. He said, "The auditor can't be wise afterward." Mr. Karl Olaf Dahl from Sweden spoke up on the same occasion, and observed, "The auditor can't sit beyond the bushes; he must look at management activity with the same assumptions that management had available at the time the decision was made."

Relieving management of responsibility is a concept which is foreign to American business and professional men and means that no item

. . . which is properly presented to the shareholders at the annual meeting in the closing statements, or in a separate report, or otherwise, can be later taken up by, say, another shareholder's meeting with a new group of shareholders in order to get damages caused

by alleged bad will or neglect on the part of the management . . .²¹

Although it is not expected that the accountant should have the same extensive knowledge and experience in all other phases of business organization that he brings to accounting and financial problems, his general qualifications are relied upon, and the mature judgment which is required of him is not something which can be delegated to an assistant. Incidentally, although great store may be set on his opinion, it is apparently recognized that if the audit work has been conscientiously performed, the liability to third parties, as far as an expression of management performance is concerned, is not the factor that third party liability is to the CPA in the United States.

Kihlman commented²² at the 1957 Congress, during the question and answer period, "It is a question of a personal evaluation and it seems difficult to have anybody sentenced for having arrived at his own opinion, provided that the audit has been made with reasonable care." He²³ sees the accountant as being required to go a step further than to draw attention to the fact that error exists, and actually give advice on how the corrections should take place. This

²¹Borje Forstrom, "Auditing the Management," The Accountant, May 24, 1958, pp. 620-621.

²²Svente Kihlman, "Paper," Proceedings of the Seventh International Congress of Accountants, 491 (Herengracht, Amsterdam, 1957), p. 461.

²³Ibid., pp. 427-431.

activity would perhaps principally fall within the area of management services in this country. The accountant, however, in Kihlman's opinion, dare not withhold himself from commenting upon faults in the organization which have arisen even from the following of the accountant's own advice by the enterprise. Certainly the auditor may have not had full knowledge of all circumstances influencing the matter, and actual conditions may have changed subsequent to the giving of the advice; it is still the responsibility of management itself, however, whatever the circumstances, to make the decisions rather than to have them made by the auditor. In fact, he dare not shrink from giving advice on questions in which he is competent, unless he is willing to face the accusation that he wanted to appear wise after the event, by waiting to see how the matter developed.

The Corporation Act stresses the fact that a personal relationship exists between the auditor appointed and the shareholders, in that it may be stipulated that the auditor may not employ any assistants in carrying out the audit--which in the case of large corporations would seem to be rather unreasonable.²⁴ Consequently some of the work of auditing is conducted by Authorized Public Accountants who work alone, but who may have one or more unauthorized accountants in their employment, and partly by firms of several

²⁴Cassel, Op. Cit., p. 109.

Authorized Public Accountants who have their own assistants. There is nowhere any accounting firm with 100 partners and assistants, comparable even to our large local firms, and no firm equivalent to one of our national firms seems remotely possible. On the average, each Authorized Public Accountant may have two or three assistants. It is possible for auditing firms to be incorporated in Sweden, although it is provided that the Authorized Public Accountant in charge of an audit is also personally responsible for its performance.²⁵

In the personal discussion in New York City during the Eighth International Congress with Mr. Kihlman and Mr. Borje Forstrom (both from Finland) it was disclosed that Mr. Kihlman has four assistants in his firm, and Mr. Forstrom has a partner, the two of them together having nine assistants. Mr. Karl Olaf Dahl, who was from Sweden, represented one of the larger firms which had six partners, and a staff of 25 persons, 10 of whom were Authorized Public Accountants.

Being faced with the requirement of commenting upon the management, the Authorized Public Accountant will give special attention to statistical reports showing financial development as well as the statutory financial statements.

²⁵Leffler, Op. Cit., p. 443.

The more important actions of the board of management may be found from examination of the minutes of the meetings of the shareholders and the board of directors. Legally significant documents such as the Charter of Formation, share subscription lists, statutes and statements showing the date the company was registered with the Registrar of Companies are examined, and correspondence regarding contracts and important written agreements are scrutinized. Reports and investigations made by the Managing Director and other executive personnel covering all parts of the company's field of activities provide an important source of information. Insurance policies covering the major risks, and documents concerning the company's taxation are also examined.

Obviously the auditor is not expected to examine all parts of the management every year, nor to dwell upon any particular detail of the parts chosen for scrutiny.

Since it is the management of the enterprise which is responsible, rather than the accountant, for the acceptance or rejection of the auditors' advice, the results are the responsibility of management. To the extent that the accountant is able to present different alternative proposals his activity can be seen more clearly to be in the nature of an advisory capacity, and management then is offered the opportunity of considering different solutions.²⁶

²⁶Kihlman, Op. Cit., p. 430.

Apparently Swedish and Finnish accountants have not seen much need for concern over the problem of objective standards. In the first place, as Mr. Dahl commented in the interview, no individual act or contract is criticized for itself by an auditor, and the withholding or recommendation of discharge of liability upon the basis of one isolated example would not occur. Mr. Kihlman contended in the question and answer session of the Seventh International Congress of Accountants in 1957²⁷ that even though an auditor is not expected to give an opinion as an expert on every sphere of management, his knowledge should be greater than the average businessman, and it is expected that he would use his ability to the fullest extent. Since the objects to be examined are so numerous, the differences depending on the size and nature of businesses, branches, ownership, etc. are so great and varied it is frankly considered almost impossible to establish any objective standards. In fact, Mr. Kihlman's contention is that such standards would more likely prove to be obstacles in presenting a report for any particular case. This portion is certainly not in disagreement with the opinion of many American accountants that rigidly enforced standards and accounting principles on a purely objective basis would do more harm than good.

²⁷Ibid., p. 458.

Several auditors may be retained by companies with many shareholders, and these auditors may have different abilities, and have been selected for their proficiency in different areas. As a matter of fact, different groups of stockholders may select different auditors, and Sections 108 and 109 of the Swedish Stock Corporation Act provide specifically for the appointment of an extra auditor to work with the other auditors if it is proposed and accepted by shareholders with a combined holding of at least one-tenth of the total capital stock. No division of work is provided for by the Corporation Act but it is expected that when a professional accountant works with a non-professional, the examination of the accounts will be done primarily by the Authorized Public Accountant, whereas the other auditors may complement the professional auditor's more general experience with useful observations during his examination of the administration.²⁸

It is agreed by all sources interviewed and examined by the author of this paper that it is rare to have a recommendation by the auditor that discharge from liability be withheld. Differences in opinion between the board of directors or the Managing Director and the auditor are ordinarily settled before the auditors' report is issued. Even where agreement cannot be reached, it is not unusual

²⁸Cassel, Op. Cit., p. 105.

for the Managing Director to mention the circumstance himself in his own annual report, in which case it is then generally felt that the auditor need not mention his objection in the auditors' report--unless the matter is so serious as to cause a recommendation that the discharge of responsibility be refused.

Since the objections in auditors' reports are so few, the auditors' work might be thought to be fairly meaningless. When it is considered, however, that the audit of management is in a large part continuous and that differences are discussed with the management and corrected in good time, it may be seen that few criticisms reach the final report. Sometimes verbal reports are presented to the Managing Director, but more frequently a detailed memorandum is submitted first by the auditor covering all reminders and proposals which, it is felt, should lead to management action. After consideration by the Managing Director, and notification of action to be taken, or his own objections, if any, the auditors can then decide whether the matter should be brought to the board's attention and whether it should be included in the auditors' report. It is customary, and considered necessary, that an auditor visit the head office of the company and the larger plants during the course of the year and that personal contact with senior officials on such visits provide valuable means for forming

an opinion of the effectiveness of administration.²⁹

The fear of losing the auditor is as great as the auditor's fear of losing his client. It was emphasized by Mr. Kihlman in a personal comment that the objection of the auditor prior to the final audit statement is not lightly regarded by the management, and Mr. Dahl pointed out that auditors may threaten to resign if their warnings are not heeded by management, in order that the auditor may avoid having to withhold recommendation of discharge from responsibility at the end of the year. In fact, the Scandinavian accountants agree that it is unusual for a new auditor even to be considered, and that surprise and shock results from any suggestion to the board that differences between the auditor and the management cannot be reconciled.

Occasionally discharge from responsibility is withheld, however, and Sillén³⁰ mentions several instances, including the following: The Managing Director of a book selling corporation had been expressly forbidden to make purchases exceeding a certain very limited amount, but despite this had purchased a large number of editions of multi-volume works having final delivery dates many years ahead even though poor sales results had already been shown. Strong suspicion of collusion with the suppliers existed, but proof

²⁹Sillén, Op. Cit., p. 6 and p. 16.

³⁰Ibid., pp. 17-18.

was impossible, even though considerable ascertainable damages had been afflicted on the company. The board had decided to dismiss the Managing Director, but agreed to grant him discharge from responsibility. Since the auditor must recommend discharge or withholding of discharge, in this case it was necessary to recommend withholding of discharge or the Managing Director would have been able to show his discharge from responsibility had been recommended.

Scandinavian accountants who discussed their auditing activities with the author in New York insisted that there was much less difference in actuality from American audits than appeared on the surface. Cassel³¹ points out that the significance of a "clean" auditor's report is about the same regardless of the statutory requirements, and indicates that nothing has been left out of the annual statements that might effect the position of the enterprise or is of sufficient importance that it needs to be brought to the notice of the stockholders. Mr. Forstrom in a personal comment went so far as to say the Swedish and Finnish auditors do not make detailed management audits at all. He maintained that Swedish and Finnish audits are not meant to accomplish the same thing as a true management audit would try to accomplish. In the discussion period at the Seventh

³¹Cassel, Op. Cit., p. 103.

International Congress of Accountants in Amsterdam³² Mr. J. E. Harris of the United Kingdom commented that after studying the Swedish and Finnish audits he felt that it was apparent and essential that the auditor was giving his advice to the management and not directly to the shareholders about management's efficiency. Management then in turn, he insists, is free to accept or reject advice as it sees fit. This approach, if true (and it was not challenged by any of the delegation from Sweden or Finland), means that the Swedish and Finnish audits accomplish approximately what a combination of management services and the traditional financial audit together would accomplish in this country. That, in fact, may account for the trend that Cassel³³ sees toward increasing size of Scandinavian audit firms, similar to practice in this country, where a number of partners are associated together, or even a corporation is in existence. This, of course, is an external form only, since Swedish law provides that an Authorized Public Accountant rather than a firm of auditors must be appointed to audit a corporation.

It would appear that meeting the requirements of the Corporation Acts in Sweden and Finland, which have grown out of a long history requiring comments regarding management performance, does not really produce an opinion

³² Ibid., p. 463.

³³ Ibid., p. 109

regarding the efficiency of management performance. To a very great extent indeed, their activities during the course of a year are not significantly different from the activities that are performed by management services divisions of American public accounting firms, except that they may be somewhat more limited in scope.

Certain advantages in regard to assuring accountability of management to shareholders exist in these Scandinavian countries, because of the specific requirements in the Corporation Acts requiring full disclosure of material which is frequently not disclosed in American financial reports. Furthermore, the auditor is faced with the statutory requirement of commenting upon the fidelity with which the fiduciary relationship between management and shareholders has been maintained.

In effect, then, the Swedish and Finnish APA's provide counsel with management regarding policies and procedures during the fiscal year in the same way that management services specialists provide counsel in the United States, and then must in addition meet strict statutory requirements regarding disclosure as to whether or not shareholders have any basis for legal action against management for breach of the fiduciary relationship. That being the case, concern about auditing standards in Finland and Sweden should not be significantly greater than concern as to auditing standards in our own country.

IV. SUMMARY

The operations audit of the internal auditor, the procedural audit of the General Accounting Office, and the statutory audit required in Sweden and Finland, all represent extensions of auditing procedure beyond the financial audit now rendered by American CPA firms. None of these extensions results in marked loss of independence or in significant problems of competence, such as would occur if CPA's were to attempt a true audit of top management performance.

What features of these somewhat extended audits can be utilized, in lieu of the management audit itself to assure accountability of management to stockholders? Is it possible for Certified Public Accountants (without jeopardizing their objectivity or over-extending their competence into areas beyond those for which their training and experience qualify them) to accomplish accountability to a more meaningful extent than the management audit itself, which is subject to so many weaknesses?

CHAPTER V

AUDITING: CHANGE AND CHALLENGE

Scrutiny of the first audits in medieval times reveals that they were for the purpose of reporting to absentee owners the fidelity with which the steward had managed resources entrusted to him as well as the current condition obtaining at the time of the audit. Even though it is recognized that operating activities are revealed in monetary terms, and can be tested in that way, these early audits were not limited to purely financial aspects, but included examination of the integrity and performance of the steward as well.

Early audits in this country tended to emphasize the matter of accountability much less than the British practice, largely because short-term bank financing was used more extensively than equity financing, and the creditor interests sought creditable information rather than equity accountability.

More recently, internal events within industrial firms have tended to render them almost self-auditing, because of the impact of electronic data processing, the development of reliance upon internal control and the internal auditor, and the gradual inclusion of accounting personnel in the management team. Simultaneously the rapid growth of

"management service" activity by public accounting firms has contributed more to administrative effectiveness and efficiency than to increased management accountability.

What specific features found in current applications of extended audit procedures can be utilized to achieve a more acceptable level of accountability?

I. SEPARATION OF OWNERSHIP AND MANAGEMENT LEADING TO INDEPENDENT AUDIT REPORTS

Early Audit Emphasis Upon Accountability

Apparently by the Thirteenth Century, English manors were equipped with a fairly complete system of assuring accountability of stewards. By that time, a survey of the manor was regularly made and certain information was listed in what was called the Extenta, which contained an account of the whole condition of the estate, any buildings on it, crops and animals held, available pasture, the amount of wood and any profits from scrap, mills, fisheries, etc. The rights and terms of tenure of the free tenants and other personnel on the manor together with their services, and any patronage or other rights belonging to the lord were also listed, which enabled the land owner to determine what the annual revenue should be, or whether any item did not measure up to expectations.

References to old documents show that the auditor (i.e. the hearer of the stewardship report) was instructed in great

detail how he could discover irregularities, and determine whether the account had been properly corrected. Indications, for example, as to the quantity of salt that should be allowed for the preservation of a specified amount of meat, are given, and the auditor was instructed to investigate the disposition of hides and fleeces of livestock which had perished, and to compare corn yield with the beginning inventory of seed-corn and the acreage of corn.¹

The auditor was usually a trusted officer of the lord of the manor and he examined in detail all accounts of stewards of the estate. Apparently some kind of combined statement of account was prepared from all accounts of officers with fiscal responsibilities, after verification of addition totals and determination of the propriety of warrants covering all expenditures. A primitive "charge and discharge" statement summarized the results, which were attested to.

There was no need of reporting financial condition or net ownership to establish credit, nor was there any interest in "profitableness."

Auditing was extended to business firms as a result of meeting the demand late in the Seventeenth Century and the early years of the Eighteenth for men of integrity and

¹A. C. Littleton and B. S. Yamey (eds.), Studies in the History of Accounting (London: Sweet and Maxwell, Limited, 1956), p. 95.

financial understanding to serve as executors of estates and trustees in bankruptcy.

Price collapses and huge investor losses has resulted from violent speculations in the share of joint-stock companies. Many felt that the immediate sale of shares rather than long-run productive use of capital had motivated foolish or fraudulent promoters in their activities.

In 1719, Parliament acted in the interest of the public welfare (believing that speculation was responsible) to prohibit the formation of joint-stock companies. This 1719 Act came to be known as the "Bubble Act" (after the disastrous South Sea Bubble), and the prohibition against joint-stock companies was to remain for more than one hundred years. Despite this prohibition, crises recurred again and again during the Eighteenth and Nineteenth century and "accountants" regularly were commissioned to help settle affairs and liquidate remaining assets.

Third party interest was introduced here for the first time for, unlike the auditor's report to the lord of the manor, the auditing of a trustee's account or acting as a trustee for creditors was an activity in which the courts usually were concerned. Thus, in a way, the courts served as an interested third party who was concerned with statements that had been audited.

It was necessary also for the first time in bankruptcy cases to distinguish between capital and income. Net

ownership of property became important and profit or loss had to be calculated, so the process of auditing increasingly required the verification and evaluation of written records, and the testing of entries by examination of supporting evidence, rather than remaining an auditory process.

The men who were called upon to perform these services certainly only rarely, if at all, had become experienced on the manor. These men had become experienced in clerical work, and because of their familiarity with the simple books of account in use, were deemed better qualified to perform the clerical procedures necessary for the formulation of a report. This new activity, representing an extension of clerical activities, could be identified with present-day management services activities of public accounting firms, for in a sense "auditing" of bankrupt companies represented simply an addition to the professional services already offered by these men. The purpose and the philosophy relate directly back to the manor, however, where an unskilled but trusted man of integrity was charged with the function of rendering stewards accountable. Today's Certified Public Accountant can perhaps trace his beginnings back to the man of letters who understood the rudiments of record-keeping, and thus was called upon to use books and records in establishing accountability--but his real obligation as a professional man is to the man of integrity who rendered stewards accountable on the manor. In fact, the word "accountancy"

is related to accountability, and the very term "Certified Public Accountant" is without meaning unless it is related to auditing activity.

The details of manorial relationships had been fairly well defined, and the steward acted as agent for the principal. In that capacity he accepted responsibilities for assets owned by others when entrusted to him, and showed his responsibilities discharged after they became someone else's responsibility. Stewardship indeed was seen as quite a different responsibility than ownership, in the eyes of British attorneys, who were accustomed to acting as trustees of the estates of decedents. Whether, under the terms of the will, debts were paid, and the proceeds of the liquidated assets were distributed to the heirs, or the property was managed for the life tenant and remainderman, both assets and debts belonged to someone else, for whom the attorney was acting in trust. Just as the attorney acting as trustee reported responsibility for various property items being assumed, and responsibilities discharged and still in his care, it seems likely that business activities were viewed with that concept of stewardship in mind. Promoters and directors were acting as stewards in the management of other parties' invested funds, and thus had to accept the related publicity resulting from factual reporting on the status and accomplishments of their stewardship--or, in other words, render an accounting.

The British Companies Acts 1844-1900

By 1841 it was recognized that continuation of the "Bubble Act" would be unwise, because excesses resulted as much from unregistered joint-stock partnerships as they had from the joint-stock companies. Fraud was recognized as not necessarily being associated with the corporate form, and it was felt that regulation rather than prohibition would make it possible once again to accumulate the huge amounts of capital required for great enterprises. During the years 1841-1844 the Select Committee of Joint-Stock Companies reported among other things that periodical accounts if honestly made and audited fairly would expose any mismanagement either from fraud or illegality. Largely as a result of this report, the Joint-Stock Companies Act of 1844 made possible incorporation by registration, but with unlimited liability. Public control was assured by requiring registration, and the Registrar of Companies had the power to deny registration to projects which in his judgment were unfit.

It was felt necessary to provide control by stockholders over the directors in their management of corporate affairs, also. Accounting records were required and provisions made for their periodic closing. A balance sheet was also required and had to be presented at each regular shareholders' meeting, and sent to the shareholders individually. The exact form of the balance sheet was not specified,

and no income statement was required. The books were to be made available to auditors who were required to report on the balance sheet at the shareholders meeting, and submit a copy to the Registrar of Joint-stock Companies for filing. No specification was made that the auditors would be professional accountants; perhaps it was thought that some would be employed by the auditors if necessary. No audit certificate was required. The report of the auditors presumably provided the shareholders with the knowledge necessary to control management effectively.

This concept of equating stewardship with accountability represents an extension of the concept of stewardship which prevailed on the feudal British estates, even though manor records dealt with physical objects rather than credit instruments.

Even though the audit provisions of the 1844 Act proved mostly ineffective no attempt was made to correct the defects in 1855 when general registration was permitted for the first time with limited liability. In fact, in 1856 when a new Joint-Stock Companies Act replaced the earlier acts, requirements for compulsory audit of registered companies were eliminated altogether. Apparently this was in response to a growing feeling at the time that matters pertaining to reporting of financial data were a private matter between shareholders and directors.²

²Ibid., p. 361.

The 1862 Act again made no provision for compulsory corporate audit and the general provisions of this Act were to remain in effect until the Companies Act of 1900. During that time numerous attempts were made to restore compulsory accounting and auditing provisions. Bills were introduced in one session after another of Parliament providing for maintenance of proper accounting records, distribution of financial statements either directly to stockholders or to the Registrar of Companies, and for independent audit. Finally under the provisions of the Companies Act of 1900 the compulsory annual audit was required once again for all registered companies. Thus again for the first time in 44 years an annual audit became necessary for all companies registered under the Companies Acts of Great Britain.

Professional Accountancy in the United States

In Britain, stewardship was stressed both as to the use of the initial capital contribution and its maintenance during risk-taking incurred in operations. The Thirteenth Century concept of accountability of stewards of feudal landed estates lent significance to later balance sheets (as compared to the income statement), and doubtless led British accountants to show non-current items at the top. Disclosure and accountability required the balance sheet to be public property; income and the results of operations were considered confidential, perhaps due partly to economic concepts of competition and free enterprise.

Lacking the statutory audit provided by the Companies Acts of Great Britain, the purpose of the auditing engagement in this country was tailored somewhat to meet peculiar American needs. As a consequence of these special needs (or rather interests) of clients in providing credit information and reporting on an accurate valuation basis, the purpose for which British audits were originated tended to become obscured.

Since corporate charters were granted by the several states in this country and early corporations were small anyway, Americans felt less need for protection of investors, who were not recruited by public offerings--especially since no great speculative losses had occurred. In fact, short-term bank loans were widely used to obtain working capital. As a consequence, reports to stockholders were less needed, and as corporate ability to repay the loans was most significant, banks were greatly interested in financial statements, particularly the current section. Thus working capital items came to be placed at the top of balance sheets in this country in contrast to their secondary position in British statements. In sharp contrast, also, was the preparation of financial statements in the United States primarily for creditors rather than as an accountability report under British Companies Acts. In other words, British accountants reported to stockholders; American accountants attested to financial data for creditors.

By the end of the First World War need for improvement seemed to be indicated regarding financial and accounting practices, at least among some corporations. By 1926 it seemed as though pressure would be required to compel improvement of these substandard practices, and the New York Stock Exchange decided to take an active part in trying to improve reporting practices. An executive assistant to the Committee of Stock List was selected. The American Institute of Accountants appointed a special cooperating committee in 1930. This committee reported in 1932 in a letter to the Committee on Stock List. A limited number of detailed suggestions was included which were designed to carry out the general objectives outlined, but essentially it was proposed that companies which were listed should disclose accounting methods used, and public accountants were to report on whether the financial statements were in conformity with the stated accounting methods and objectives.

The Exchange authorities were impressed by the recommendations but by this time there had occurred the great stock market crash of October 19, 1929, the political campaign of 1932, and the effects of the Great Depression were beginning to be felt. Other events and influences such as the Florida land boom, the exposure of excesses caused by pyramiding of holding corporations, questionable treatment of stock dividends, etc. added to the feeling that unless there were government control of corporate securities

markets, the confidence of the general public would probably not be restored again.

The Securities Act of 1933 and the Securities Exchange Act of 1934 were passed as part of the "New Deal" emergency program. Under these Acts not only was the issuance of securities regulated, but accounting was established as an important instrument in the accomplishment of that regulation. Although specific references to auditing procedure were not included, methods of preparation of the statements, valuation of balance sheet items (particularly insofar as depreciation is concerned), and separation of recurring and non-recurring income were all left to the Commission to prescribe.

It will be noted that the provisions of these two acts establishing and providing continuing control over relationships between the promoters or management and the body of stockholders were akin both as to purpose and procedures to the British Companies Act of 1845. To be sure, the immediate short-run goal of the British Act was to make the corporate form of business organization available and to protect investors from fraudulent promotions. The corporate form was already well established in this country, on the other hand, but it was felt that governmental regulatory action was necessary to protect the investing public in the securities markets.

Registration of listed securities was required for the first time in this country, and distribution of annual

audited statements became necessary for such listed companies. That the provisions of these acts and the Investment Company Act of 1940 have only been partially successful in accomplishing their objectives may be due in part to the fact that only a very small percentage of the corporation in business in the United States actually have to register and become subject to SEC regulations. Or perhaps it may also be due partly to the fact that CPA's by that time had become accustomed to reporting in effect for management to creditors primarily (but also of course to stockholders as well), rather than reporting for the shareholders themselves.

One hundred years before in Britain a rationale had been developed in support of these provisions. It was used for the first time in this country after creation of the SEC. Adequate accounts were to be required to be kept, they were to be audited, the reports were to be filed with a government agency and they were to be distributed to stockholders because it was believed that promoters and executives had stewardship obligations to shareholders, that these obligations should be prescribed and legally enforced, and that the public interest required full publicity as to the company's formation and the annual status of its financial condition thereafter.

At long last, and by means of a most circuitous route, United States law requires that management report to shareholders of the major corporations. The intent of the law

is to render management accountable to the shareholders. During the period required for the development and acceptance of this concept, however, new problems and challenges faced the accounting profession which have served to limit the scope of financial examinations, and have forced the fashioning of new audit techniques.

II. CHANGING AUDIT TECHNIQUES

In Montgomery's fascinating book, Fifty Years of Accountancy³ we get an idea of the audit procedures of 1890 or thereabouts:

Fifty years ago when we started an audit we were handed what were known as all of the books of account--the ledgers, journals, cash, purchase, and sales books, together with cancelled checks and paid bills. When we verified all the entries and vouched all the payments, we were pretty much through with the job.

Since that time dramatic modification in detailed auditing procedures has occurred as a result of automated record keeping, a vast increase in the number of business transactions, and the upgrading of the personnel of clients and CPA firms alike.

Electronic Data Processing

Certified Public Accountants have had to accommodate in the past few years to the impact of electronic data processing. The sight of literally thousands of cards being

³Robert H. Montgomery, Fifty Years of Accountancy (New York: The Ronald Press Co., 1939), pp. 17-18.

processed in the machines led auditors at first to scrutinize the cards themselves which was both laborious and fruitless-- but they were concerned about the ease with which cards might be substituted. Bewildered because there was no traditional audit trail which enabled them to follow a transaction directly from the original source to the ledger, they failed to realize that the cards could be re-sorted and used again for printing a tabulation which lent itself to traditional methods of audit examination.

To be sure, the arrival of the electronic data processing equipment on the scene meant new problems and challenges for the auditor. Problems of even greater magnitude have resulted from the recent use of coded or magnetic tape taken directly from original documents, and which cannot be interpreted by someone who is not familiar with the code. More records all the time are being put on magnetic tape, and the detailed records (particularly intermediate details) are available only in the magnetic form (if they are available at all). Even the filing or indexing of the original document, if one exists, is done in a manner which minimizes the sorting and filing costs, but tends to make subsequent location by the auditor difficult.

On the other hand, electronic data processing has introduced the concept of machine processing as being a separate responsibility center, which separates the record keeping function from the handling of the transactions, and

thus is considered a desirable feature of internal control. Alternative controls such as a greater control over source data can be established to replace missing traditional internal controls. More elaborate precautions can be followed in regards to verifying the first recording of a transaction in the operating department itself. Independent control totals, also, of a "nonsense" nature such as employee numbers, quantities, etc. assure the completeness of the numerical sequence even though they have no value in themselves. The machines themselves can be assigned the job of editing the input data in order to ascertain the presence or absence of punched holes in fields where they belong or do not belong. For example, the use of logical relationships can be provided for, such as provision of both debit and credit location charges for each inventory transfer. Punched holes that would call for an illogical entry such as charging material to earned surplus can be rejected by the machines. Payroll checks can be controlled by providing that no employee time report allows for more than 50 hours per week to be entered. And, of course, the machine summaries or listings can always be referred back to the original department for review.

Daily preventive maintenance for processing control and intermediate and end review which serve to highlight unusual circumstances and exceptions (for example, total payroll, quantities, purchase prices, failure to collect

credit sales within a certain period of time, etc.) add to control elements.

As a matter of fact, the electronic data processing equipment can be programmed to test or audit itself. Indeed many of the problems of auditing electronic data processing installations which seemed so frightening at first can be solved during the initial programming phase. Adequate audit trails as well as exception reports can be built in at the time the application themselves are being designed. Electronic data processing lends itself particularly well to providing special items automatically for intensive examination. Examples would be customers' account balances that exceed a stated amount, or which have remained uncollected over a certain period of time. Maximum inventory quantities can be established or inventory items which exceed a certain unit price can be segregated for attention. Auditing by exception has proven very beneficial, and lends itself particularly well to the high speed processing facilities of the electronic equipment.

Since electronic data processing has an effect upon the availability of data and the means by which the basic information becomes a part of the completed statements the auditor has need to modify his examination in order to satisfy himself that the system established minimized opportunity for irregularity. Certainly he must develop a familiarity with the functional capabilities of the equipment

itself and must concern himself with the overall controls that are established to safeguard the entire program. In addition much can be done in the modification of the audit program itself in order that the auditor may verify basic and intermediate data either at a time when it is available or when it can be secured with a minimum of interference with normal company operations. This may involve more forward checking and the auditor may have to time the details of his audit examination so as to be available himself when the information is available rather than making it necessary to rerun obsolete data or to prepare duplicate runs of great quantities of material exclusively for the use of the auditor.

Since the auditing process involves satisfying the auditor as to the correctness of the original entries by means of comparison of the original source material with some input data either at the time of its origination, or satisfying himself by means of other devices that the program does indeed produce what it is intended to produce, he must verify that all entries formulated were actually tabulated and review the system of machine balancing controls and the records maintained to check against the tabulations. In summary, the auditor's examination consists in large part of satisfying himself that the control built into the electronic data processing system is adequate, rather than in any detailed testing of data on his own part.

Internal Control

One of the most important developments that have served to modify audit techniques is the auditor's reliance upon internal control. This has made it possible for the auditor to abandon detailed checking of transactions and to rely upon testing and sampling techniques. This development is rather recent although reference to the effect of a good system of internal check upon audit procedures may be found as far back as 1929.⁴

The scope of examination is always determined, of course, by the auditor himself and he must decide whether the interests of both stockholders and creditors would be protected by extending any particular area of examination. Actually both the decision as to appropriate audit techniques and the size of the sample are influenced by the reliance he places upon the client's system of internal control, so he is indeed duty bound to review its functioning and satisfy himself as to its effectiveness.

In 1958 the Statement on Auditing Procedure No. 29 of the American Institute⁵ lists two types of internal control:

⁴United States Federal Reserve Board, Verification of Financial Statements (Washington, D. C.: Government Printing Office, 1929).

⁵American Institute of Accountants, Committee on Auditing Procedure, "Scope of the Independent Auditor's Review of Internal Control," Statements on Auditing Procedure No. 29 (New York: American Institute of Certified Public Accountants, Oct., 1958), pp. 36-37.

- (a) Accounting controls comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, the safeguarding of assets and the reliability of financial records. They generally include such controls as the systems authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing.
- (b) Administrative controls comprise the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls.

As was recognized in Chapter III it is management's responsibility to establish administrative controls, to promote policies encouraging efficiency in production and distribution, through personnel selection and supervision, to maintain an internal communications network to execute its policies, and to police personnel performance. But this is not entirely alien to the accountant's area of responsibility, either.

On the other hand, assuming that accountants have given their attention to the problem of accounting controls, have developed in fair detail the principle features of an adequate system of accounting controls, and have tended to give this matter attention in all aspects of the audit, internal accounting control is not exclusively an accounting problem for it goes well beyond accounting. It should aid and assist policy rather than to criticize or judge.

The review by the CPA of the system of internal control does serve an additional purpose beyond the formulation of an opinion as to reliance that may be placed upon the system of internal control. Recommendations for possible corrective measures are indicated where the review shows that apparent weaknesses exist, and these should be directed to management. Presumably this is a secondary aspect of the CPA's review and goes beyond the services that are ordinarily associated with his independent examination of the books and records in order to render an opinion as to statement presentation. This recommending of corrective measures is an aid to management in attaining more efficient operation. To the extent that this operates for the benefit of shareholders the shareholders should be delighted to have it accomplished. Obviously, of course, it does not assist in any way with the rendering of accountability on the part of management to the stockholders.

Internal developments in the larger corporations within the last few years have made it possible for the independent CPA to rely to a great extent upon an examination of the system of internal controls by the firm's own internal auditors. This development, like the increased use of electronic data processing equipment, has enabled the CPA further to reduce time spent in detailed checking where an adequate system of internal control exists and to give more attention to the adequacy of the system of

internal control. Where internal auditors are regularly on the payroll of the client firm, moreover, the internal auditors are qualified to evaluate the effectiveness of the system of internal control themselves, and the Certified Public Accounting firm need only satisfy itself as to the adequacy of the examination by the internal auditors. In fact, traditional audit procedures involving detailed examination by the auditor of individual transactions are no longer necessary in larger firms and the examination by the independent public accountant has been abridged to a very great extent. In fact, the large client may feel self-sufficient with his extensive internal controls, his internal auditors, his systems and tax specialists, and his specialized management personnel.

Personnel

Concurrent with the growth in the number of transactions of client firms, there has been an upgrading of the quality of personnel both in the client firm and in the Certified Public Accounting firm. Consequently a more sophisticated approach to testing and sampling data has evolved as more adequately trained auditors began to perform the audit function. In cases where formulating an opinion concerning a substantial volume of data is necessarily made on the basis of testing, the statistical techniques now in use will not change the auditing standards but will make it possible to render a more valid opinion. Statistical

techniques are helpful not only in the evaluation of the findings themselves, but in planning the actual audit program.

Clients with highly qualified personnel on their own staffs, and faced with large public accounting fees for the use of highly trained specialists representing CPA firms, have come to ask for more than merely an opinion on financial statements. Presumably the independent auditor will thus be free to devote greater attention to the consideration of proper application of sound principles of accounting, and still reduce the overall audit time.

Further, the increasingly professional approach of the internal auditor enables him to do much more than the routine junior-level work which can be relied upon by the CPA in formulating an opinion in regards to the fairness of financial statements. The CPA, of course, should concern himself with the manner of preparation and distribution of the internal audit reports and with the action taken by management as a result of the report.

The effect of all of these items, the growth of the use of electronic data processing equipment, the reliance upon the client's system of internal control, and the upgrading of personnel both in the client's office and in the office of the CPA have served to modify and restrict the detailed examination formerly required of the CPA in order to render an opinion regarding the financial

statements of the client. These changing audit techniques have not served to any great extent to alter the presumed purpose of the audit itself, which in this country apparently still is more heavily concerned with reporting profitability, liquidity and solvency for the benefit of creditors than with establishing the accountability of management as stewards operating property in behalf of the stockholders. These changes, however, have helped make the importance of so-called "management services" vastly greater within the past few years.

III. MANAGEMENT SERVICES

Management services by Certified Public Accountants may be defined as those services which are designed primarily to facilitate management decisions: to assist management with respect to operational deficiency; to assist management in identifying, surveying, or solving problems; or to assist management in the development, implementation or involvement of improved accounting or management techniques and procedures.⁶

Almost inevitably the CPA is led beyond the performance of activities directly related to accounting into other aspects of the management task--first probably into the area of what might be called managerial accounting (e.g. budgeting, cost accounting, cost analysis, operating and cost control, and problems of office operation and office

⁶James E. Redfield, A Study of Management Services by Certified Public Accountants (Austin: Bureau of Business Research, The University of Texas, 1961), p. 24.

equipment). Next he may be called upon to render such services as acting as arbitrator, primarily because of his reputation for integrity and independence. Management services are frequently performed in conjunction with other expert advisors such as attorneys, investment bankers, insurance counselors, and industrial engineers, who often have actually been added to the staff of the management services division of the accounting firm itself. Excluded, of course, is the performance of any significant management duties for the client, so that the CPA does not manage the business or make managerial decisions for the top decision-maker.

A most important distinction between management services activity and traditional public accounting services is to be found in the location of ultimate responsibility of the two areas of activity. The opinion statement by the CPA is a report for the benefit of external interests, presumably for stockholders but actually for the general public, particularly creditors. This means that the auditor's ultimate responsibility should be to outsiders rather than to the client's management, even though management is responsible for paying the auditor's fee. Certainly the point of view in a traditional audit report is that of reporting upon the financial performance of the company to outsiders, even though done in behalf of management.

On the other hand, however, management services activity tends to identify the "independent" accountant with

management, and recommendations are directed to executives. Even in situations where he is called upon to appraise performance of middle management or particular functions of the business, his interest is more in terms of assisting the company management, or at least approaching the financial facts and figures from the point of view of their practical usefulness to management in decision-making activities.

Other differences distinguish management services activity from traditional public accounting engagements. The activities are seldom routine in the same way that verification of detailed data in an audit would be, and likewise they tend not to be repetitive, each task or each assignment representing a different challenge. The report rendered is naturally unique each time, too, since a stereotyped report or tax form is not the end result as in the case of traditional auditing services, and very seldom is there a presentation of simple historical data. More importantly, the staff member engaged in management services will find that problems referred to him overlap the various operating functions of a business, and may in fact not be primarily related to any one of them.

Growth and Extent

During the First World War management services were increasingly performed, although apparently incidental to the performance of audit and tax engagements. During this

time the "efficiency engineer" gradually shifted his emphasis from improved factory management to improved general business management, which again involved the accountant in a wide range of practical business questions relating to finance, business policy, economical production, prevention of waste or extravagance, and even personnel problems.

World War II brought a rapid expansion of management services again because the management and production problems created by the war called for unprecedented professional consulting assistance, in addition of course to the regular audit and tax work.

At the present time audits are required by the SEC for nationally listed companies, and there is no foreseeable relaxation of that requirement. There seems to be a growing feeling, however, that unless the Certified Public Accountant increasingly expands his services beyond auditing and tax work he cannot maintain his professional position in the financial community and with his clients. Unless he extends the scope of his activity to include service identified with profit maximization and in the assistance of management with its difficult task of managing assets committed to them there is a distinct possibility that these managements needs will be met by other professional men.

Actually one reason for the development of management services activity by Certified Public Accountants is the changing status of the industrial accountant himself. He is

now an important member of the management team and becomes involved in all phases of business operation including production, marketing, and research as well as finance. It is only natural that the public accountant then would be expected to participate in consultation with him on similar matters of policy significance. It is widely recognized now, too, that management may prefer to assign special projects to competent staff members of their CPA firm rather than to involve their own personnel and interfere with their regular responsibilities.

There is considerable evidence that just as the medieval auditor while hearing the steward render the accounts of the lord of the manor might inquire as to the relationship between actual performance and ultimate or maximum expectations, the distinction between auditing and management services is likewise somewhat arbitrary. There is some question in fact as to where auditing should begin and end. Every area of activity in any department and on the part of any employee must eventually be reflected in the accounting records, and even reports and data which do not appear on the surface to have any significance as far as formal financial records are concerned do have dollar significance in terms of management's responsibility.

The practice of establishing a different division in a CPA firm for management services (separated from the audit staff) is simply a recognition that concentrated

attention is required to follow rapidly changing developments and methods. It also makes it possible for the management services group to spend several months of service time necessary on a special project, which would work a real hardship on an audit staff which services many clients on a recurring basis, thus limiting time available for extended work of a special nature. Despite the separation of these groups into two staffs, however, the two groups tend to work very closely together, and the cooperation is helpful to both division. The audit staff inevitably develops a vast reservoir of information through previous experience with client affairs and this is often helpful to the management services personnel. On the other hand, the audit staff finds its work facilitated by being able to draw upon procedural or other changes in client organizations which can be made known to them through the records of the management services staff.

Accountants within the course of their audit activities regularly come into contact directly as well as indirectly with all other phases of management. Unable because of the pressure of the audit program to give attention to them, these may then be referred to the management services staff for investigation if it is the wish of the client.

Competence

At the present time the only standards of competence and ethics are those which have been established for the practice of auditing itself, which are subject to interpretation by the individual CPA firm. The CPA is presumed to make certain that he is qualified to render a particular service under the circumstances before he offers it to the client. If he does not feel qualified and feels that he can supervise or evaluate a specialist's work he can assign it to someone on his staff who is qualified, or he can advise the client as to other professional or technical consultants. It is conceivable, of course, that he can improve his own qualifications by studying or taking additional training.

The public accounting practitioner has, however, developed certain qualities from his experience that are of great value in rendering management services, because an objective point of view, the habit of relating particular phases of operations to the overall earnings effect, an analytical approach to complex problems, and (perhaps most important of all) facility in dealing with top executives of client companies, are all of great significance in rendering management services.

Even so, the quality of supervision and evaluation would appear to be the essential criteria in determination of a firm's competence. Differentiation can be made⁷

⁷Ibid., p. 27.

between "competent supervision" and "competent evaluation." Since supervision implies the ability to direct performance of an engagement, and evaluation indicates, on the other hand, the ability to appraise the performance or results of an engagement, both are essential in the performance of management services. Unique problems as to competence have resulted from the existing rules of the profession that a specialist generally cannot be admitted to partnership in a CPA firm until he passes the CPA examination. Consequently then the mere addition of a specialist to the firm would not add to the competence of the firm unless he could be supervised and the results of his work could be evaluated, or in other words, the firm's competence is never any broader than the combined competence of the individual CPA's who have become partners, regardless of the individual qualifications of employees.

It would appear actually, however, that the same standards of competence are not necessary for management services as are necessary for auditing practice, any more than the same standards would be required for audited statements as for statements prepared without audit--except that questions about competence in management services activities inevitably lead to questions about competence in auditing areas as well.

The separation of activities within the public accounting firm itself emphasizes the different objectives

of the auditing and management services divisions. This could also be true of standards, particularly if it is stressed that management services reports are not issued as reports for third parties by CPA's and they are not attested to.

The problem of prohibiting the admission of a non-accounting specialist to firm partnership is probably of a transitory nature, associated with the sudden accelerated demand for management services, and problems of recruitment. There would seem to be no compelling reason why the partners of the future could not be both CPA's and specialists in some phase of management services activity.

Certain problems of competence do, however, remain in connection with the performance of management services. In the first place, present basic accounting training does not necessarily qualify men to be advisors to top management. Further there are no existing accepted standards of the quality of work in this area to guide the CPA in management services activities, and no referral system exists to permit assigning responsibility to someone better qualified. As a matter of fact, there is little professional exchange of information at all. Since the approach in management services differs so dramatically from audit activity, the problem of adequate supervision of technically trained specialists performing non-CPA work is a matter of serious consequence. The problem of preparation for management

services itself presents additional problems. Junior accountants cannot often be used, because the work is of a nature that requires mature, experienced men, and routine clerical activities are not ordinarily required. From this the question follows as to the source of replacements for staff men who retire or leave the employment of the public accounting firm. Other special problems involve the uniqueness and irregular nature of each assignment. Since each one is special in itself, no body of experience is available to guide management services specialists in future engagements. In management services, too, a certain amount of public relations work is desirable and some methods appropriate to the securing of management services engagements are incompatible with the professional approach of the Certified Public Accountant.

Independence

Even those who are most ready to admit the difficulty of an exact separation between auditing services and other traditional public accounting services are concerned that management services have been extended to the point where the practitioner who is engaged in time will become so intimately associated with the management of client companies that the management's mind may in effect be made up as to a course of action in terms of the recommendation of the CPA himself. However, the survey phase of a management services

engagement should gather, coordinate and analyze basic information. The engagement might even be broad enough to tie together all the basic management functions--except formulation of the decision itself. Presumably instead of relying upon any specific recommendation by the management services specialist the actual decision will be made by management on the basis of a careful evaluation of the suggested courses of action which have been postulated by the Certified Public Accounting firm.

The Certified Public Accountant brings qualifications to management services which are useful in maintaining the independence of his firm from involvement in actual decision-making for clients. Historically the Certified Public Accountant has jealously guarded his independence, and he has established recognized standards of performance and examination for which he is responsible in his audit work.

Some problems still remain in drawing up and applying a code of professional ethics which will be equally applicable to management services as well as to auditing activities. The ethical commandment, however, that no professional person can ethically do indirectly what he is prohibited from doing directly is applicable to the problem of developing standards and ethics for the conduct of management services.

The gravest problem of all deals, however, with the question of independence, and the possible inability of the

consultant to separate himself from the actual decision which presumably should be made by top management itself. Certainly there is danger that a quasi-employee relationship may evolve as a result of management services activity, and the CPA, instead of considering himself independent, finds himself identified with the viewpoint of the client. Although a certain amount of this is inevitable in a tax representation, the degree of involvement in management services activity is conceivably far greater. If there is a slightest hint that the Certified Public Accountant himself has participated in the decision-making process, he obviously is no longer able to act in a completely independent capacity in the rendering of an audit opinion. Certainly management influence can make itself felt and the Certified Public Accountant is in danger of the loss of strict objectivity in regards to his audit activities. Perhaps most likely of all is what has been called⁸ the development of "intense interest." For example, the auditor might be reluctant to provide for an allowance for inventory price decline subsequent to his own recommendation for inventory increases.

The recent recognition of the importance of management services, and the growth and extent of that type of services,

⁸
Ibid., pp. 30-33.

have served somewhat to reduce the emphasis upon and interest in the financial audit report, despite questions regarding the competence of CPA's performing management services, and ethical considerations regarding their independence when involved in management services.

To the extent that management has been able to do a better job of managing, the stockholders have benefited by management services activities. However, the closer identification of the Certified Public Accounting firm with management itself, has served further to endanger the extent to which the traditional audit can be expected to establish accountability of corporate management to its owners.

IV. ASSURING CORPORATE ACCOUNTABILITY THROUGH EXTENDED AUDIT PROCEDURES

Auditing has been shown to be historically associated with accountability, and the financial statements resulting from the regular CPA audit examination represent the only attempt at the present time to make top management accountable to the stockholders, whose security for their investment is represented by a measure of control. Since 1934, legislation in this country has required that financial statements be published (presumably to stockholders, in recognition of the historic concept of accountability being equated with stewardship.

Present Financial Statements

The financial statements resulting from present independent audits by CPA firms do serve an important purpose. In the opinion of the author the attest function of lending credibility to financial statements prepared by management is an important one, even though it is of greater importance to creditors perhaps than it is to stockholders. Furthermore the financial statements presumably are still the best overall indication of management performance.

Present financial statements, however, do suffer from certain limitations. In the first place, bookkeeping processes necessarily produce summary information, and published financial statements then represent the result of the opinions of accounting executives as to what should be summarized, and the extent to which it should be summarized. Decision is also made regarding the amount of detail to be included in the financial statements, and which items should be singled out for special attention. The resulting statements then necessarily are so brief, the dollars involved are so great, and the number of transactions are so enormous that their usefulness is impaired. Furthermore, the possibility is quite large that major trends or transaction summaries serve to offset each other, so that the effect of each is covered and lost by inclusion of another.

In the second place, the limitations of internal control are probably inadequately recognized by practicing

accountants. Accountants tend perhaps to be too compliance-minded and view internal control as the means whereby conformity of performance to standards is assured, but examination and analysis of internal control only assures that the objectives of the person or persons formulating the objectives are being met. To the extent then that good internal control is relied upon by the auditor in formulating his opinion regarding the fairness of statement presentation, he is only reporting how successful employees and middle management are in doing what top management wants them to do. There should be, however, a higher goal sought for the opinion statement of Certified Public Accountants: the establishment of accountability of top management in pursuit of an evaluation of their stewardship. Thus, in effect, lacking full accountability to stockholders, the only top management controls existing are those self-imposed by top executives, which is not intended in corporation law or in the statutes requiring independent examination of the financial statements.

In the third place, the problem as to what is a "good" profit is not presently being answered at all by audit reports. It is certainly conceivable that a firm might show only nominal profit or a loss--but which would be remarkable indeed considering the limitations against which the management has struggled (for example, long established faulty capital structure which could only be modified by financial

resources greatly in excess of those available to management under the present circumstances; a declining industry, such as a baby casket manufacturer facing a drastically declining infant mortality, or a firm whose raw material supply has been rendered unavailable by war or catastrophe). On the other hand, it is equally conceivable that a firm with substantial profits is so strongly financed, and so well established in the market, that it would be most unlikely for management, no matter how inept, to have a poor profit showing. Of course, the definition of "poor" or "adequate" or "exceptional" profits is a matter of judgment, and as such hardly qualified as an objective standard by which to judge management's overall performance.

In the opinion of the author, present auditing and reporting standards fall short of meeting today's requirements. Verification of the accuracy of historical accounting accumulations is not sufficient justification for the audit report. The Certified Public Accountant has too long enjoyed the great good fortune of being able to deal with static historical data and with relatively riskless hindsight. For too long a time, the CPA has been willing merely to say in effect "Here is what happened; and this is the way things now are," rather than to take any responsibility for informing the parties which the audit is designed to protect as to the meaning of what has happened and the possible future prospects.

It may well be that the auditor of today's complex business enterprise may not be able to state categorically whether or not management is efficient and it may be that an independent judgment regarding the effectiveness and integrity of management would have little meaning without more objective measurement criteria, but the CPA certainly is both in a position to give some evaluation of the meaning of the statements, and morally obligated to do so.

There must be a change in the emphasis of the present financial audit. Distinction can be made between "verification of accounts" and "interpretation of accounting activity," and the verification of accounts may well diminish for reasons outlined previously, but the interpretive part of the audit must be extended. An obvious place to begin would be to extend the attest function to cover special purpose accounting statements as well as the conventional financial statements. Within obvious limits the traditional statements measure historical results; what is equally as badly needed, however, is some indication for judging the foresight of management as regards preparation for the future, which may be found by an examination of the budget, organization structure, and operating policies in effect. In considering the problem of accountability it is obviously impossible to separate the reporting of past performance from the stimulation of remedial action. That means, for example, that deviations from objectives should be pointed

out, and the report should reflect changes in objectives. To be sure, it might well be inappropriate to recommend a specific course of action, but interpretation of the figures could indicate the location and need for action instead. Not even historical accounting, however, has been squeezed dry by the public accountant; it might conceivably be possible, for example, to estimate what profits might have resulted from alternative decisions. Comments regarding the validity with which overhead and other charges are distributed could well be made and would assist in disclosing better the value of decisions made by management.

Present concepts of internal control should be expanded to consider it as a nerve center of accountability and (rather than limiting this information system to traditional financial data) should include all elements of quantitative information. Recognition of this fact would lead to further expansion of the attest function and would broaden the scope of audit examination.

Modification of present auditing standards would not solve the problem of accountability of management to stockholders, but modification of the audit approach would help, if used together with other recommendations which follow. The present published financial statements are indeed minimal, and the auditor could well assume responsibility for extending them beyond merely historical reporting so as to emphasize the interpretive aspects of auditing

and make them more forward-looking than has been done in the past. Audit programs should also be modified to recognize that purely financial accounting is only a part of the information system of the modern complex corporation, and that the auditor's opinion should cover all quantitative data, instead of limiting it to purely financial data.

Full Disclosure

Accountants have been accused⁹ of tending to define accountability in terms of the accuracy of individual items or transactions. The auditor, obviously, should be more concerned with evidence supporting a fair presentation of summarized transactions for a particular period and at a particular time. Bray predicts that the auditor will soon be expected to do more than verify and justify, and perhaps will even be expected to attest to "the objective reality of the accounts and conceptual measurements." He refers apparently, in this manner, to what has been called the "interpretative phase" of auditing, and in effect he seems to be saying that true accountability is not established by detailed checking of thousands of transactions, but by "editorializing" the data accumulations, and expressing an opinion as to their meaning. This seems to be really a problem of full disclosure, and the concept of "full

⁹F. Sewell Bray, The Interpretation of Accounts (London: Oxford University Press, 1957), p. 190.

disclosure" recognizes that the inclusion of more information in the audit report does not necessarily mean better disclosure; it is not so much a matter of the quantity of material disclosed that is important but rather the kinds of information which are revealed.

There seems to be no particular reason why standards of responsibility such as have been developed in auditing could not be extended both to tax and to management services activity by professional accountants. There is no reason why formal reports in writing on all data with which CPA's have become associated, whether internal or external, could not be given, and an explanation included of what has been done, together with an indication of what responsibility is assumed.

It is perhaps in this area that the GAO audits have made their greatest contribution. The GAO auditor assumes a responsibility which CPA's have been reluctant to assume: to report as objectively as possible on significant findings, whether or not they can be objectively quantified. GAO auditors do not seemingly feel that they permit themselves to become vulnerable in reporting on any matter, so long as they are able to present convincingly the pertinent facts they have been able to uncover so as to show clearly the basis and reasonableness of their conclusions. This approach imposes the obligation on an auditor to include in his report his findings in sufficient detail that unjustified inferences

are not made that his findings necessarily evaluate management's overall performance. As has been previously pointed out, it may not be necessary to present certain material in terms of quantity. An effect can be reported in other ways than a precise measurement of value in terms of dollars or units--by describing its nature and significance in words, for example. Estimates of the dollars or units possibly involved would be helpful to show the materiality of the item in the auditor's opinion, but so long as they are indicated as estimates they need not be derived with the degree of precision necessary for inclusion in the traditional opinion statement of CPA's.

It appears inevitable to the author that professional accountants must move away from the Short-Form reports, and back toward Long-Form audit reports. Frequently Long-Form reports are indeed prepared, and supplied only to management, or perhaps the members of the board of directors. The type of information presently contained in the Long-Form report, and other information which could be added, would be of great significance to stockholders as well as to management. Modification would certainly be possible in order to protect information which is considered undesirable to disclose because of competition, but items pertaining to the sales in units as well as dollar amounts, the trends of particular products, and the profitability of divisions or contracts, accompanied by ratios and comparative figures would be very

helpful to stockholders as well as management. The tax status of the firm with respect to the period reviewed by the Internal Revenue Service, pending tax negotiations and deficiencies and over-assessments, summarization of the insurance in force and a discussion of personnel problems, factory organization, and production policies would be desirable. The July, 1957, Statement of Auditing Procedure, No. 27 "Long-Form Reports" issued by the American Institute of Certified Public Accountants, emphasizes the importance of maintaining distinction between management's representation and the auditor's representation and conclusions, and, in like manner, explanations should be distinguished from exceptions or reservations. The present important distinction between the auditor's opinion as to management's statements, and factual representation made in addition to those with respect either to statements or the records themselves must be continued.

Without jeopardizing the distinctions emphasized by the American Institute's recommendations on Long-Form statements, a great deal of additional material could be shown. It would seem that in very few, if any, cases would all of the following be included, because of the inclination to "play it safe" and to present a minimum amount of material, rather than too much--but in many cases a substantial number could well be included:

1. Trends as to sales and earnings.
2. Prospects of non-recurring profits or losses.

3. Tentative plans for expansion of plant and products.
4. Statement as to the dividend policies decided upon.
5. Research and development policies and programs.
6. Litigation pending either by or against the firm.
7. Any financial matter of an unusual nature presented by the CPA to the board within a reasonable period.
8. Changes in executive personnel or labor relations pending.
9. New financing needed, and intentions as to source.
10. Leases and contingent liabilities.
11. Previous exceptions presented to the management privately, which have not been acted upon, together with the information as to how long a period of time these "exceptions" have been repeated.
12. Current or assessment values of real estate.
13. Adequate disclosure of any transactions between officers (or companies in which the officers are represented) and the company itself.
14. Adequate disclosure of officers' activities in trading in company stock.
15. The total amount of salaries and wages, including fringe benefits and stock options, of all executives above middle management.
16. Any changes in regard to prior balance sheets as to classification of assets, changes in depreciation computation, or the valuation of any assets.
17. Events occurring since the end of the fiscal year of material significance.

A management audit, in which an opinion is rendered as to the efficiency and effectiveness of management efforts, was rejected in Chapter III, as being predicated upon untenable propositions as to top management job descriptions and the validity of standards of measurement. Accountability requires something more than an opinion as to administrative effectiveness; it requires full disclosure of factors that establish the honesty and integrity with which management has used the stockholder's resources. Conventional audit reports could well be modified to include considerations already mentioned: (1) extension of current auditing procedures to include forward looking elements and elements

quantitative in nature, whether or not they were directly financial, and (2) a re-definition of the meaning of full disclosure which would probably result in the increased use of the Long-Form statement.

Further steps toward assuring accountability might be in terms of modification and expansion of the management services consulting function.

Combination of Management Services and Auditing

A combination of management services activity with traditional auditing would not be essentially different than the activities of Finnish and Swedish Authorized Public Accountants. It will be recalled that their engagement is a continuing one, that management consults with them during the year, and any possibility that the auditors might not be able to recommend that management be discharged from liability would have been discussed and resolved generally before time for the audit report. That this is not essentially different from engagements in the United States was emphasized by Scandinavian accountants in interviews during the 1962 International Congress of Accountants in New York. Accountants have always of necessity been vitally concerned with operations as well as the summary accounts themselves; for example, an inexperienced junior accountant (the first time on a new audit) is regularly first taken through the factory of a client in order that he may have some concept

of the operations which will be reflected in the accounts. The Scandinavian system is essentially a combination of management services and traditional auditing--although the management services activities of the Authorized Public Accountant in Finland or Sweden do not seem to be as broad in scope as the management services performed by American firms. It is clearly, however, a case of the auditor wearing two hats: first he works with management in an advisory capacity, and then at the end of the fiscal year furnishes a report indicating among other things the effectiveness of management performance (or at least the honesty and integrity of management).

The management services approach to broadening the scope of CPA activity would probably not meet with as great hostility as would, for example, the attempted establishment of an independent management audit. GAO officials in Washington suggest that the procedural type of audits performed by GAO staff members are in fact frequently rendered by practicing professional CPA's under the guise of management services--but carefully avoiding any implication that the CPA is to be considered a guarantor of the contents of his report.

The question as to whether the CPA can serve two masters: management and stockholders (management in terms of management services, and stockholders in terms of an opinion report) has usually been met until the present time

by effectuating a division within the public accounting firm itself. Management services are performed by a special group of people; and the traditional audit is performed by a different group, each of whom have their own capacities, standards, scope of activity, and the greatest possible extent of independence as to each other. It may well be that what is required instead is simply a reformulation of the goals of the profession.

It seems inevitable that increased quantitative counsel and assistance to management in performance of its tasks must soon take the place of the traditional audit program which has been fairly well reduced to a review of internal control and the programming of self-auditing devices into electronic data processing installations.

New objectives for the profession might well be formulated and might take somewhat the following form:

1. Forecasting and projecting tentative operating plans and programs should develop from an extension of the present scrutiny and analysis of transactions.
2. Rendering an opinion as to the fairness of statement presentation requires increased consideration of the client's control network, including assistance in formulating and maintaining procedures regarding personnel and equipment and the preparation of timely summaries of all types of quantitative data.
3. Independent and informed opinions traditionally rendered by CPA's lead naturally into providing extended economic and financial assistance for management.
4. Opinion as to the honesty and integrity with which management has discharged its fiduciary responsibilities to owners can be objectively formulated and should be disclosed.

Concern over independence as applied to management services activity does not seem to be really significant. As an auditor the CPA has always been engaged by management (in fact if not in theory), paid by management, and subject to dismissal by it. He has a long record of service to the company and its management, and inevitably develops personal friendships with client personnel, no matter how careful he is to avoid that. Financial pressure, however, to attempt to retain the account (together with the pressure of personal friendships), is fortunately largely balanced by opposing pressures. Not only is the CPA morally liable to third parties relying upon his opinions, but the liability is legally enforceable. Frequently his work is subject to a certain amount of re-audit by agencies of the government, or by some other firm of CPA's.

What is often misunderstood is that a consultant may perform the same function that an employee performs without becoming an employee and becoming subject to management authority. It is also frequently overlooked that influence and authority are not at all the same, and regardless of the extent of influence of a consultant, authority is vested elsewhere, as pointed out in the previous discussion of Scandinavian audits. These two distinctions in combination with the forces that always have worked to assure independence of the audit itself, would seem to indicate the likelihood of independence being no greater problem for management

services activity than it has been in threatening the integrity of the auditor in the conduct of his usual audit activity.

At least one major public accounting firm has already moved to extend audit service to become what is called an "operations audit." This plan involves assignment of management services personnel on regular audit engagements, where they would be expected to make a review (the detail depending upon the nature of the client's business and problems) from a management viewpoint. The management services specialists would work directly with the audit staff. The results of this exploratory examination would be reviewed with the client in order to suggest ways in which a program for improvement could be developed. It is recognized that more work for management services personnel may be generated from such activity, but the primary purpose seems to be the developing of client appreciation of the interest that the firm has in its general welfare. A further benefit is seen in the partnership of the audit staff and management services personnel working together on the same engagement.

The partnership of the audit staff (working presumably upon factual material) and the management services division dealing with intangibles and subjective data does not in itself create any great problem. Financial audits themselves have never been completely factual and objective, for the principles of accounting for financial transactions have been

developed in such a broad way that the exercise of judgment is always present. Consequently financial statements reflect judgment as well as factual material, and the statement of opinion regarding the fairness is after all an exercise of judgment itself.

To be sure, any attempt to appraise future potential of a firm, even to the extent indicated by the combination of audit staff and management services personnel, represents a basic change in the philosophy of auditing as it is now practiced. For CPA's even to take a small step toward accepting the role of reporting on the effectiveness of all functions of their client's business represents a modification of present audit philosophy; to accept the role of appraising the sincerity and honesty of management requires additional change yet.

The appraisal of honesty and sincerity of management, after all, is the only essential difference in the Scandinavian certificate, but it should be noted carefully that there is no attempt by Finnish and Swedish accountants to tell how "good" management is. The continuing relationship all year long, in a form similar to our management services, provides the type of assistance which our management services divisions are providing. The report of Scandinavian accountants, however, including a recommendation of legal necessity that management be granted discharge from liability for their management is no more than the American auditor should be

satisfying himself of, and be willing to attest to. It was shown in Chapter II that management is related in a fiduciary capacity to the stockholders whose property they manage; an audit examination should reveal at the very least whether the highest fidelity to the interest of the corporation has been exercised by management and its duties have been discharged with reasonable care and reasonable prudence. Then why not say so?

Analysis of Profit Sources

One final step could be taken by CPA's in this country to assist greatly in rendering management accountable, and that would be to take advantage of the Charge and Discharge approach of reporting on estates. Lawyers and accountants have long charged themselves with assets turned over to them, together with assets subsequently discovered, plus any gains on realization of assets. They credit themselves with debts and expenses paid, with the distribution of legacies, and with any loss on realization of assets. The balance remaining is then accounted for. In this statement any actual gain or loss (i.e. profit) is not so important as to establish the integrity with which the trustee has managed the assets delivered to him.

It is necessary, however, and probably always will be necessary that the auditor indicate a net income figure as being his fair estimate of the results of operation. A

great deal, however, could be done with the net income figure to suggest management's responsibility for that end result.

In the first place, any profits which are purely fortuituous (i.e. are not in any way the result of management activity) could be segregated and stated separately. The segregation of such windfall profits (or losses) could be done without developing any new standards, and would seem to be substantially free of subjective influences. A second way, in which analysis of profit sources could help identify management effort would be to separate the effects of price fluctuation from the other factors affecting income determination. This conceivably could be a somewhat involved problem when executives have foreseen price fluctuations, and have adapted their policies to attempt to take advantage of them, as for example in inventory buildups, and capital acquisitions. So long, however, as it is not necessary to come up with exact dollar or unit figures, complete disclosure of the evidence, and the reasoning upon which the auditor's tentative conclusions are based, would seem adequate in terms of GAO experience.

In the third place, it would be quite useful for many analysts as well as share owners to be informed of the effect of imputed income and expense. Here again, estimates strengthened by the discussion or explanation as to their computation would be sufficient. An opinion regarding the

effect of sunk or opportunity costs on policies and future operations would also be helpful, and could be presented in exactly the same manner.

These recommendations offer a more reasonable, workable system of assuring management accountability to owners than the management audit, which is superficially appealing, but practically of little use.

CHAPTER VI

SUMMARY AND CONCLUSIONS

Honesty and prudence are called for in the management of corporate assets which have been provided by common stockholders, who (unlike other contributors of capital) must rely upon control as their security. Lack of effective means of assuring such performance is demonstrated in this thesis, which means that responsibility granted to executives must once again be equated with accountability if government control is to be avoided.

Accountability was accomplished on English manors before 1300 A.D. by having an "auditor" hear stewardship reports, for the purpose of satisfying absentee owners as to the fidelity and honesty with which stewards had handled resources entrusted to them. This concept of accountability was extended to corporations by the British Companies Acts, but in this country these original audit objectives were modified, and American CPA's render an opinion primarily on the propriety of financial statements, despite SEC attempts of the 1930's to stress accountability of management to owners.

Management theory specialists have suggested a management audit, which presumably measures the effectiveness and

efficiency of management. The management audit cannot accomplish what is claimed for it, however, because there is difficulty inherent in the measurement process itself in connection with the development of standards, which must reflect fluid organizational goals. No standard can ever determine how really effective performance is--it can only measure its conformity to the arbitrary standard. Furthermore the unstructured, creative duties of the modern executive are so vast and ill-defined that they do not lend themselves to measurement which is precise enough to render an opinion as to the effectiveness of management performance. It will be impossible (at least within the foreseeable future) to render an opinion upon the effectiveness of management, except in general terms as indicated by the financial results of overall operations.

Accountability, however, does not depend so much upon the actual effectiveness of management performance, as upon the full disclosure of the honesty and sincerity with which management has attempted to discharge its fiduciary responsibilities.

Current applications of extended audit procedures suggest means by which accountability can be assured. The operations audit of industrial auditors is indicative of the feasibility of extending audit techniques to include (at the very least) internal controls of nonfinancial functions, and perhaps even actual appraisal of the function

itself. The policy audits of the GAO calmly and clearly describe how faithfully financial responsibilities of agencies have been discharged. Scandinavian Authorized Public Accountants meet the statutory requirement of commenting upon the fidelity with which the fiduciary relationship between management and shareholders has been maintained.

The following audit modifications would provide a sufficient measure of accountability of management to the common stockholders, whose only security is their right to participate in the management of the corporation:

1. Changing the emphasis of audit procedures to include all quantitative data and to be more interpretive and forward looking in their scope.
2. Placing a far greater reliance upon full disclosure, involving greater use of a Long-Form statement together with a complete description of what has been done and the basis for any conclusions reached.
3. Recognizing the desirability of combining management services and auditing in somewhat the same way it is done in Scandinavian countries, including a recommendation in the auditor's opinion (accompanying management's financial statements) to the effect that management should be discharged of its liability (which in effect attests to its integrity and sincerity).
4. Analyzing profit sources in terms of tentative assignment of responsibility for the operating results, rather than a flat statement of the amount of income.

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