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INTERNAL AUDIT AT THE HISTORICAL HUDSON'S BAY COMPANY: A CHALLENGE TO ACCEPTED HISTORY

Abstract: The accepted history of managerial internal audit is that its origins are in financial and compliance auditing. Managerial was added after firms started to expand geographically or into other businesses. That expansion increased complexity and created problems for managers which the internal auditor assisted in solving with managerial audits. Contrary to that two stage development, something comparable to managerial internal audit was being practiced by the Hudson's Bay Company in the form of inspections as early as 1871. Rather than in financial and compliance auditing, these inspections had their geneses in the desire of the senior manager and the committee (board of directors) for additional information on the fur trade and retail operations. This paper will describe the inspection function at the historical Hudson's Bay Company, the circumstances leading to the development of this function, and how it complemented other controls.

INTRODUCTION

Generally, internal audit is thought to have started with financial and compliance audits. It arose as the growth and increasing complexity of firms in the early 20th century stretched the capabilities of managers and thereby created efficiency and effectiveness problems. By adding managerial activities to financial and compliance, internal audits were recognized as a means of assisting overburdened managers.[1] This two stage history — first of financial and compliance, then of

[1] Managerial internal audits are considered to be the same as those described as comprehensive, efficiency and effectiveness, modern, operational, and value for money.

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managerial internal audit — has been accepted in the literature on that subject. However, a recent examination of the archives of the Hudson's Bay Company (HBCA)[2] has suggested that the two stage history of internal audit may not be universally applicable. Inspections very similar to managerial internal audits were conducted at the HBC in 1871 — about 50 years prior to the generally recognized commencement of managerial internal audits. Moreover, these inspections were introduced by the HBC at a time when the complexity of the organization was actually decreasing.

The purpose of this paper, therefore, is to challenge the accepted history of internal audit by showing that something comparable to managerial internal audit had developed earlier at the Hudson's Bay Company (HBC) for reasons different from those advanced in the conventional history of internal audit. The next section discusses in greater detail the accepted history of internal audit. Subsequent sections put forth the background and the development of inspections at the HBC, respectively. The inspection function at the HBC is then assessed and compared to managerial internal audit using a contemporary definition. The final section contains the concluding comments.

THE ACCEPTED HISTORY OF INTERNAL AUDIT

Managerial internal audit appears to have been classified as a 20th century management innovation [Flesher, 1977, p. 190; Brink and Witt, 1982, pp. 5-6]. It has been defined as:

> . . . a systematic, objective appraisal by internal auditors of the diverse operations and controls within an organization to determine whether (1) financial and operational information is accurate and reliable, (2) risks to the enterprise are identified and minimized, (3) external regulations and acceptable internal policies and procedures are followed, (4) satisfactory standards are met, (5) resources are used efficiently and economically, and (6) the organization's objectives are effectively achieved - all for the purpose of assisting members of the organization in the effective discharge

[2] The archive covers the entire company history except for the last 30 years, which are still confidential. Researchers access the 1670 to (approximately) 1914 materials via microfilm which can be borrowed. Most post-1914 materials are restricted in their use because they have not been catalogued and microfilmed.

> of their responsibilities [Sawyer, 1988, p. 7; Sawyer and Vinten, 1996, p. 25].

This definition — which "seeks to focus on the broad scope and objectives of internal auditing and to encapsulate its comprehensive approach" — alludes to the two stages which have been noted by numerous authors. Generally, the two stages have been expressed as financial (and compliance) audit followed by the addition of managerial audit. In an article entitled "Modernization of Internal Audit" Flesher [1977] noted:

> . . . the old concept of internal auditing can be compared to a form of insurance. The major objective was to discover fraud much more quickly than it could be discovered by a public accountant during an annual audit. The modern concept of internal auditing is that of an "arm of management". No longer is the internal auditor strictly a policeman, the modern internal auditor is an integral link in the management process [p. 190].

Similarly, in their textbook *Modern Internal Auditing: Appraising Operations and Controls,* Brink and Witt [1982, pp. 5-6] recognized two stages to the development of internal audit. They noted that the earliest concerns of management were whether: the assets of the organization were being properly protected, company procedures and policies were being complied with, and the financial records were being accurately maintained. At the same time there were concerns with fraud detection and the coordination of internal auditing with the work of the external auditor. Brink and Witt also noted that as operations increased in volume and complexity, new pressures were placed on senior management. To assist managers, internal auditors took on a broader and more management-oriented set of activities.

Chambers [1980] documented the same shift in the focus of internal audit by examining The Institute of Internal Auditors' Statement of Responsibilities of the Internal Auditor, namely:

> The 1947 and 1957 editions carried the clause 'internal auditing . . . (reviews) accounting, financial and other operations' but only the 1947 edition included the clause 'internal auditing . . . deals primarily with accounting and financial matters but . . . may also properly deal with matters of an operating nature'. By 1971 both of these clauses had been dropped in favor of 'Internal auditing . . . (reviews) operations'. So while in 1947 the accent was on financial accounting matters,

> by 1957 there was a balance between these matters and the audit of other operations (usually called 'operational auditing'); and by 1971 financial matters were simply regarded as one of many operations, not meriting special mention [p. 275].

Sawyer [1979] also recognized the importance of The Institute of Internal Auditors in the development of managerial internal audit, namely:

> Victor Z. Brink's recollections of internal auditing reach back to the beginning of a discipline which I like to think of as management-oriented internal auditing. He was there [1941] when it crawled out of the cocoon of financial ticking and toting and first spread its wings. The discipline might have had its origin in the ancient verification of financial transactions, but it started to mature when Brink and a few others brought forth The Institute of Internal Auditors, Inc. [p. 23].

In one of the few historical studies on internal audit, Boockholdt [1983] examined the origins of internal audit in 19th century U.S. railways. He attributed the introduction of financial internal audit to the growth in size and the westward movement of railways [p.70]. More specifically, as the railway companies began to conduct large-scale financial transactions at widely dispersed geographical locations in the 1840s, they appointed internal auditors to monitor the processing of financial transactions. In the U.K., Pollins [1957] reproduced a letter of 1867 from the external auditors to the shareholders to reveal the internal audit activities at the London & North Western Railway. The letter stated:

> That the main check, as between the Board and its numerous servants, devolves of course on the large establishment at Euston called the Audit Office, headed by a responsible Officer, who has eight in-door assistants, seven out-door inspectors, and a staff of 127 clerks. . . . The verification made by the Auditors, assisted by the Public Accountants, is therefore as between the Board and the Shareholders — its object being to ensure that the Books are kept upon correct principles, that the published accounts are in accordance therewith, and that they honestly lay bare to the proprietors the true condition of the undertaking [pp. 16-17].

The letter indicated that the "Audit Office" was involved with auditing payment vouchers, debenture registers, stock and share registers, dividend accounts, cash balances, station revenues, and rents due. The focus was financial and not managerial.

Managerial internal audit did not gain much recognition until the establishment of The Institute of Internal Auditors in 1941. It has been accepted that in the early 20th century many American firms expanded their operations in terms of geography, product lines, and functions — that is, they became vertically integrated — which led to large and complex organizations that were difficult to manage. Chandler [1962, pp. 9-11] noted that to make these firms more manageable, a decentralized structure was implemented with the following components: (1) a general office at the top (with general executives and staff specialists) which coordinated, appraised, and planned goals and policies and allocated resources for a number of quasi-autonomous, fairly self contained divisions; and (2) divisions for carrying out the strategic decisions of the general office. The divisions consisted of: (a) a central office that administered a number of departments, each with functional responsibilities such as manufacturing and selling; (b) department headquarters which in turn coordinated, appraised, and planned for a number of field units; and (c) field units which were responsible for plants and sales offices.

As part of the appraisal function at these complex early 20th century firms, it was inferred by Williamson [1975] that the general offices of these firms (which were described by Chandler [1962]), sent internal auditors to the divisions to assess financial and operational controls. Internal audit was an integral and complementary part of the control systems which consisted of strategies, plans, and budgets (as ex ante controls) and operating statements, return on investment calculations, and various operating reports (as ex post controls). As the general office executives were isolated from the divisions, internal audit was important for validating the divisional performance contained in abstract financial reports [Williamson, 1975, pp. 146-148]. More specifically, Williamson [1975] suggested that the internal audit function produced information not available to open-market transactions:

> The auditing advantage of internal organization in relation to interfirm organization is attributable to constitutional and incentive differences which operate in favor of the internal mode. An external auditor is typically constrained to review written records and documents and in other respects restrict the scope of

> his investigation to clearly pertinent matters. An internal auditor, by contrast, has greater freedom of action, both to include less formal evidence and to explore the byways into which his investigation leads [pp. 29-30].

Penno [1991, p. 521] adds an important proviso for maintaining internal audit objectivity. Penno demonstrates that to be objective the internal audit unit must report to a sufficiently high level in the organizational hierarchy. With the internal audit unit reporting to a low level in the hierarchy, there would be a tendency for biasing in favor of the manager overseeing the internal audit unit. Reporting to the chief executive officer and/or the audit committee of the board leads to fewer biases and more objective findings.

It was noted that The Institute of Internal Auditors had a significant effect on the development of managerial internal audit. Thus, the recent change in its definition of internal audit is likely to be significant [Krogstad et al., 1999]. Its previous definition and the new definition are contained in Exhibit 1. Although this is the profession's definition, and likely self-serving, it is based on extensive surveys of practice. The new definition could be ushering in a third stage of internal auditing, but at present it is too early to substantiate this. The striking difference is that the previous definition sees internal audit as an appraisal function within the organization, whereas the new definition sees internal audit as concerned with assurance and consulting services. The previous definition presupposed that internal auditors examined and evaluated activities. The new definition gives internal auditors the general responsibility for adding value by improving an organization's activities. The previous definition had auditors assisting members of the organization in the discharge their responsibilities; the new definition is more general in helping the organization accomplish its objectives. With the previous definition, internal auditors provided analyses, appraisals, recommendations, and information about activities. The new definition has internal auditors bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control, and governance processes [Professional Guidance, 2000].

To summarize, the previous definition or what has been called managerial internal audit assumed that internal audit was an extension of management. This was a necessary role as financial information was incomplete for effective management. The new definition has internal auditors as partners with senior management in developing systems. Financial

EXHIBIT 1
Internal Auditing Defined

The Institute of Internal Auditors' Definitions of Internal Audit

Previous Definition. Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed. The audit objective includes promoting the effective control at reasonable cost.

New Definition. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Source: Krogstad et al. [1999, p.29]

information may still be incomplete, but with low cost computing and enterprise resource planning systems (such as SAP and PeopleSoft), managers have many other sources of information at their disposal to address that incompleteness. Consequently, internal audit as a profession is being forced to find a new mandate.

This section has noted that the accepted history of internal audit has exhibited an interaction between the need for internal audit by organizations and the provision of internal audit by the profession. With that context, the paper will now explain the background to inspections and their development at the HBC, both of which predate the internal audit profession.

BACKGROUND TO THE INSPECTIONS

The HBC, the oldest commercial organization in the world that continues in its original line of business [Milgrom and Roberts, 1992, p. 6], was established by the King of England in 1670. Immediately upon being granted a charter, the HBC located posts at the mouths of rivers flowing into the Hudson Bay, in the northeast part of North America. The HBC was successful in pursuing a strategy of waiting at bayside posts for the aborigines to come down those rivers annually to barter their furs for European goods. Competition later emerged from "pedlars" who were willing to go inland from Montreal to the south and west of the Hudson Bay to save the aborigines long and arduous trips. To meet this competition the HBC, in 1774, established its first inland post. This was followed by many other posts in the next decades until the strategy of its trade changed from bayside to inland posts.

In pursuing the inland trade strategy, the HBC was competing with various trading partnerships from Montreal who eventually joined together to form the North West Company (NWC). The competition was described as peaceful coexistence [Carlos, 1981, pp. 778-781]. There was no collusion, and predatory competition did not occur until 1816 [Carlos, 1982, pp. 176-181]. Then in 1821, with both companies suffering, the HBC merged with the NWC, retaining the HBC name [ibid., 1982, pp. 180-181]. After the merger, George Simpson was put in charge of the Northern Department, while William Williams was responsible for the other, smaller Southern Department. In a few years, Governor Simpson was responsible for all North American operations, a responsibility he retained until his death in 1860.

Management was challenged during this period because of three types of uncertainty: (1) inland travel on rivers and lakes, (2) trade conditions, and (3) "living off the land". These categories related to major groupings of parts, activities or means-end chains in the fur-trade operation.

Inland travel activities were particularly complicated. Ships from London had to be unloaded and the trade goods and supplies stored in warehouses at the ports or directly loaded into canoes and boats for shipment to posts. The trips took weeks or months, and for each day there were demanding tasks in order to maneuver man-powered canoes or boats along rocky-bottomed rivers and lakes. These trips often required portages or the carrying of the canoes, boats, and their contents around rapids or waterfalls, or from one water system to another. Portages were physically demanding on the men. In short, inland travel was problematic for three important reasons. First, all employee actions were unobservable. Consequently, effort and diligence were not always explicitly known. Second, employees were subject to opportunistic behavior. They were not always willing to give priority to the HBC's interests. For example, after 1774 when competition forced the HBC to move inland, employees exerted all forms of effort in their resistance to go inland [Burley, 1993, p. 5]. One of HBC inland governors noted in 1820 "that there is a great want of subordination in general amongst the people" [transcribed by Rich, 1938, p. 51]. Third, there was environmental uncertainty from random events. The arrival times at various posts could not be predicted as weather and environmental factors interfered with schedules. Moreover, the exact distances and best water routes between posts were uncertain.

Trade conditions were uncertain because of the lack of a monetary system. A large number of furs were traded for an even larger number of European trade goods. Prior to the move inland, North American aborigines had developed a system of middlemen for transporting furs to bayside posts. The distant aborigines who did the trapping would often trade with those who made the trip [Innis, 1970, pp. 137-139]. However, this system of middlemen started to unravel when the HBC moved inland and dealt directly with aboriginal trappers. Trade was further complicated by the larger number of different aboriginal groups with different languages and customs. Moreover, the behaviors of traders were not observable, and thus it could not be ensured that they acted in the best interests of the HBC.

There was no infrastructure inland, and in contrast to posts located on the Bay, all food and clothing requirements could not be sent from London because of high inland transportation costs. To pursue inland trade, living off the land was necessary, but highly uncertain. Food and clothing had to be supplied locally at dozens of posts either by HBC employees or through trade. Hunting, fishing, and farming were also pursued, subject to transformation uncertainty as employee behavior could not be observed. Weather was always crucial for these primary activities, but it varied significantly according to seasonal conditions and geographical location. Hunting and fishing were precarious because of the unpredictable migration patterns of prey. In addition, the short growing seasons and infertile soils (especially at some northern posts) yielded poor and uncertain crops.

To manage the North American fur trade operation in the face of this extreme uncertainty, Simpson fully implemented and improved upon the accounting and control practices introduced by the committee of the HBC (comparable to a modern-day board of directors). These practices were described by the committee as "a Radical Change in the System of Carrying on the Trade" [HBCA, reels 6 and 39]. Although the inland trade strategy commenced in 1774, the accounting and controls did not reflect the new strategy until 1810 when profitability problems, aggravated by external factors, incited radical change [Spraakman, 2000, pp. 12-13].

The accounting and control practices perfected by Simpson in the 1820s can be described as mechanisms for directing and monitoring operations [Roy and Spraakman, 1996, pp. 64-69]. The five mechanisms for directing operations – organizational structure, outfits, indents, councils, and standards – will be briefly examined in turn. The monitoring mechanisms will be discussed thereafter. First, the organizational structure of the HBC was hierarchical with the shareholders electing a committee of seven members plus the London-based governor and deputy governor. The committee appointed the inland governors. For the North American operation, individual trading posts in the same vicinity were grouped into districts for managing. In turn, districts were placed geographically into departments. The departments were headed by governors, as noted, while districts were generally headed by chief factors; posts were generally directed by chief traders, while the smaller posts were the responsibility of clerks. Second, the HBC trade practices centered on the annual outfit. Trade goods and supplies comprising the outfit were sent from London at the beginning of the outfit year. Third, an indent or list of trade goods and supplies requested for the next outfit was sent to the committee in London. The HBC used a series of indents to plan and coordinate the movement of trade goods and supplies over a two or three-year cycle. Fourth, departmental chief factors met annually at convenient locations with the inland governor, and perhaps some chief traders, to interpret instructions from the committee and to establish rules and regulations for the conduct of the business. With communications and transportation being slow and expensive, these councils were important for establishing direction and for achieving coordination. Fifth, given the existence of a barter system there was a standard of trade which each post developed to ensure that the furs received would cover all costs and generate a profit. The standards of trade related all furs and all trade goods with a prime beaver pelt (designated a "made beaver"). These standards provided explicit instructions on the furs to be obtained for each trade good as well as for an entire outfit.

The six monitoring mechanisms were: inventory records, accounting records, journals, operational data, councils, and the annual review of operations [Roy and Spraakman, 1996, pp. 69-74]. First, inventory records were detailed and kept for all trade goods and supplies in monetary and physical terms with reference to the actual post or depot location. In movement from port to depot to post considerable effort was devoted to tracking inventory with packing slips, invoices, and other records. Second, accounting records furnished the committee in London with the cost of furs from each district. This district record was a "balance sheet" which was actually a ledger account and part of the debit and credit bookkeeping system. Specifically, it was a means of closing the district books at the end of the outfit year, and thus a culmination of the year's activities for the district and its posts. With the scale of prices (a list of recent market prices for furs provided by the committee), the profit (or loss) of the district could be estimated prior to the actual sale of furs. The balance sheet contained the following (abbreviated) debit and credit items:

Debits	**Credits**
Beginning inventory	Inventory supplied to other districts
Shipments received	Servant debts, and advances
Servant wages	Sale value of furs (based on the scale of prices)
Profit (if one)	Loss (if one)
Total debits	Total credits.

Third, journals — the narrative records of daily occurrences — were maintained by the senior employee at each post. The journals recorded what work was done by employees each day, the names of aborigines coming to trade, the arrival of the outfit and shipments of the furs [HBCA, reels 1M116 and 3M224]. The purpose was to provide the committee with a "better understanding" of the activities at posts. Fourth, during Simpson's governorship operational data were important. Distances and load weights were recorded with the intent of improving efficiencies. Fifth, at the annual council meetings the governor and chief factors reviewed the performance of posts and shared operational information. Sixth, Simpson gathered information about operations during his legendary visits to posts. During all but three of the thirty-nine years he spent in charge of the fur trade, Simpson crossed the North American continent [Newman, 1987, p.304]. These visits provided important sources of information for his annual reports to the committee. The actual performance of each post, and district, was compared to that expected for the year, expected for future years, and achieved in past years.

In summary, during the period from 1821 to 1860 the directing and monitoring mechanisms of the HBC emphasized operational planning. If there was a single description of the approach to the HBC's management during that period, it would be "getting the inventory to the right place at the right time for profitable trade".

THE DEVELOPMENT OF INSPECTIONS

After Simpson's death in 1860, the annual tours were maintained to a lesser extent by his successors. This was due in part to Simpson's successors Dallas (1860 to 1864) and Mactavish (1864 to 1870) being less rigorous in their scrutiny and inspection of fur posts [MacKay, 1936, p. 284]. They did not have his extraordinary energy. This reduction in ex post control, plus increased competition because of the modernization of transportation, soon resulted in operational problems. These were discussed in a report dated 1871 by Cyril Graham, who had been hired by the committee to examine the fur trade, the relations between the company and its officers, and general business prospects [HBCA, reel 733]. As a partial solution to the operational problems in the fur trade, inspections were formally established in 1871 with the creation of four inspecting chief factor positions [HBCA, reel 526]. Their duties included visiting posts and districts, examining the books, reporting on the condition of facilities, evaluating personnel, and making recommendations for improvements [Ray, 1990, p.15]. At the same time, the structure of chief factors and chief traders reporting to the commissioner (the new title for the inland governor) was expanded by two more positions. The managers subordinate to the commissioner now included, in descending order: inspecting chief factor, chief factor, factor, chief trader, and junior chief trader [HBCA, reel 3M232].

Initially the inspecting chief factors had line authority over districts and reported to the commissioner on fur trading posts and districts, and, later as they were opened, on the retail saleshops. As they were more senior than any of the post or district managers whose operations were being inspected, the inspecting chief factors were regarded as authority threats [Ray, 1990, p. 71]. Later, the title was changed to inspecting officers with the elimination of their authority over post, saleshop, and district managers. In a memorandum to the committee in 1888 the commissioner described the differences between two positions:

> I would call attention to the difference between an inspecting chief factor and the present inspecting officers. The inspecting chief factor used to go into a district clothed with authority and as the senior of the

> officer in charge. This undoubtedly had the effect of undermining the authority of the officer in charge of the district, the maintenance of which I believe to be vital. At present the inspecting officers, bearing no additional rank in virtue of their office as Inspectors, visit the district or post and in no way interfere with authority of the officer in charge. Their duty is to report to the commissioner and for the commissioner to take actions. The difference between action being taken by the commissioner or by the inspecting officers being very great in the eyes of the officers. In the one case there is hearty concurrence and in the other suspicion and jealousy [HBCA, reel 745].

The responsibilities (or scheme) of the inspecting officers as at 1886, which are presented in Exhibit 2, are strikingly similar to the duties of modern-day managerial internal auditors. This list of responsibilities was attached to the aforementioned memorandum from the commissioner to the committee [HBCA, reel 3M224]. Moreover, virtually the same checklist was used with inspections for the next three decades. The emphasis of inspections was neither financial nor compliance as expected by the accepted internal audit history. Instead the initial emphasis was on managerial auditing. There were two reasons for this. First, the persons completing the inspections were seasoned managers. Second, the financial component was relatively small; of the eight sections to the scheme, only one dealt with the accounts. Moreover, even the accounting section was approached from a managerial perspective. For example, a typical inspector made the following observations in the first decade of the 20th century:

> The acting manager is . . . weak in collections, and showing a want of discrimination in granting credit . . . Too long credit is given. Taken generally the accounts are unsatisfactory, and the collection of them will require immediate attention, while great caution in granting further credit will require to be exercised [HBCA, reel 525].

The other seven sections of the scheme dealt with responsibilities of the manager in charge, such as buildings, stock, and furs. In addition, the tone was managerial. For example, in the "General" section, points one and two read, "can trade of post be improved", and "can additional posts be opened or present closed with advantage", respectively.

It is important to note that inspectors were being intro-

EXHIBIT 2
Scheme for Inspections, 1886

a. Buildings
   1. condition.
   2. situation.
   3. suitability.

b. Stock
   1. verification of inventory.
   2. suitability.
   3. sufficiency.
   4. condition.
   5. time of turn-over.
   6. saleable stock (list attached) with suggestion for disposal.
   7. live stock.

c. Furs
   1. quality.
   2. is post obtaining full portion of best skins.
   3. is the trade affected by tariff.
   4. increase or decrease of fur-bearing animals.

d. Accounts
   1. cash book.
   2. examination and classification of outstanding balances (with list attached and marginal notes). Is each account current, if not, is debtor a regular customer.
   3. verification of debts.
   4. securities (with list attached and remarks).
   5. capital employed. How often turned over.
   6. percentage of apparent gain to capital.
   7. audit.

e. Expenses
   1. mess expenses or commutation.
   2. gratuities to servants and [aborigines].
   3. miscellaneous expenses.
   4. possibility of reduction of expenses.
   5. transport and cost-landed.

f. Personal
   1. business capability, suitability and personal character of all attached to post.

g. General
   1. can trade of post be improved.
   2. can additional posts be opened or present closed with advantage.
   3. opposition.
   4. division of territory.
   5. route of goods and return.
   6. remarks on general character of business with anything met under preceding heads.
   7. conditions of [aborigines].
   8. list of outposts.
   9. when last visited by officer in charge of district.

h. Suggestions

Source: HBCA [reel 3M224].

duced while the HBC was becoming easier to manage because of improvements in communications and transportation instigated by the coming of steamboats, railroads, and the telegraph. The HBC went along with this modernization which, after 1860, gradually reduced the three forms of uncertainty which impacted on its operations. First, inland travel by birch bark canoe and crude boat was replaced by more predictable and less expensive steamboat and railway transportation. Second, the HBC no longer had to provide food and clothing for its employees as an infrastructure developed across western Canada for those purposes. Third, a monetary system replaced bartering.

Modernization caused the HBC to be a simpler business to manage, and led to changes in the way it directed and monitored its operations [Spraakman and Davidson, 1998, pp. 83-93]. First, with a relatively simple business (despite expansion into retail saleshops), the HBC evolved to a flatter and more centralized structure with the commissioner firmly in charge. The department level was eliminated and districts were streamlined through the consolidation of posts. Communications and transportation improvements allowed the commissioner to be more directly involved in the affairs of the less uncomplicated posts and saleshops. Consequently, the number of managers (chief factors and chief traders) declined. In 1887, the commissioner gave as the reason for this decline, "the requirements of the service would be met by a smaller number of officers than at present hold commissions" [HBCA, reel 3M232].

Second, with better communications and transportation, and the development of local Canadian and American suppliers, the HBC was no longer dependent on the annual outfits from London. Third and relatedly, indents became less important because it was unnecessary to plan months or years in advance for trade goods and supplies. Ordering could be done from local or North American suppliers as needed, or just before needed. Indents were used primarily for ordering items from England, which was a decreasing portion of the total order of trade goods and supplies [HBCA, reels 3M230, 3M232]. Fourth, improvements in communications and transportation made councils unnecessary as the commissioner could easily contact posts or saleshops to coordinate the shipment of trade goods, supplies and furs, assign employees, and introduce rules and regulations. Fifth, the standard of trade was no longer needed as market prices existed for furs and trade goods.

Monitoring mechanisms also changed. First, with inventory more readily available and the one to two year wait no longer necessary, the importance of inventory decreased along with the importance placed on inventory records. Second, the financial records underwent dramatic changes. Instead of showing debits on one side and credits on the other with profit (debit) or loss (credit) as the balancing item, the balance sheet evolved into the trading account with the following line items in descending order: sales, direct costs, gross margin, expenses, and apparent gain. The HBC used these trading accounts to manage posts and saleshops as to their capital employed and their return on capital employed [HBCA, reel 508].

There was another related change to the accounting records. The commissioner in 1891 proposed to change the accounting from outfit to fiscal year end [HBCA, reel 508]. When using outfit years, the books were not closed until after the sale of all furs in London, which was one year or longer after the May 31 year end. This also meant that the district accounting reports had to be completed at the London office. The resulting accounting system was complicated and expensive. However, more frequent sales led to annual reporting which also allowed the district accounting reports to be completed in Winnipeg; this gave the commissioner more frequent information which allowed for decision making to be more centralized with him.

Third, operational data became less important for two reasons: financial information became more important, and the councils were discontinued, thereby eliminating the opportunity to discuss operational data. Fourth, posts, saleshops, and districts continued to prepare annual reports, which tended to be explanations of financial statement line items and responses to inspector reports, rather than assessments of operations. The in-depth discussions that the committee had in their annual letters to posts were replaced with discussions of inspection reports. Relatedly, the annual reports submitted by the commissioner became largely discussions of operating statement line items. Fifth, the number and frequency of council meetings declined after 1860; the last took place in 1887. There was a marked decline in the sharing of information and experience. Sixth, journals were still prepared, but reviewed less frequently. There were fewer managers to review the journals.

In summary, a new system of management developed during the period 1860 to 1914. It can be best described as management by numbers. The structure was flattened and authority was centralized. Indents, outfits, inventory records, operational data, and standards were de-emphasized. Councils were discontinued as the commissioner did not need them for directing or coordinating purposes. Instead of elaborate ex ante and ex post management mechanisms, the system was simplified. The commissioner directed the posts and saleshops with simple indents and outfits, and fewer standards, but with explicit feedback. The feedback came in two parts. The main source was detailed post and saleshop trading accounts, which included the capital employed and the return on capital employed. In addition, the HBC employed inspecting officers to regularly visit posts and saleshops in order to report to the commissioner on operations.

AN ASSESSMENT OF INSPECTIONS

Sawyer's [1988, p. 7] and Sawyer and Vinten's [1996, p. 25] definition of managerial internal audit, discussed in the second section of this paper, is now used to assess the HBC's inspections from 1871 to 1914. More specifically, this definition provides seven criteria for assessing the inspections.

(1) *Systematic and objective appraisal*. Inspectors only proceeded to posts or saleshops when requested by the commissioner [HBCA, reel 745]. Their duties were to give complete reports to the commissioner using for fur posts the eight ("a" to "h") headings in the scheme (in Exhibit 2), carefully separating facts from opinions or suggestions. Sections "a" to "g" dealt with factual conditions, while section "h" contained the "suggestions". For efficiency, inspectors used pre-printed forms that allowed them to write the number (e.g., item 1 from section a) rather than the actual description (for example, for item 1 in section a, buildings, the sub-description was "condition") with their assessments.

The inspection steps were established a priori with concern for a systematic process. Inspection reports were shared with the person in charge of the post or saleshop, and then sent to the more senior managers. For the fur posts, district managers made recommendations for remedying shortcomings, to which the commissioner added his own recommendations in a letter attached to the copy of the inspection report sent to the committee. An example is the commissioner's letter of 1893 discussing the inspections of the Athabasca and McKenzie River districts [HBCA, reel 820]. The accompanying ten-page letter to the two district managers contained inspection summaries for the district office and fourteen posts, plus a comparative statement of aboriginal debts which were problematic at some of the posts. Judging by their comments in return letters, the committee carefully read the commissioner's letters discussing inspection reports as well as the actual inspection reports [e.g., HBCA, reels 3M177 and 3M178].

Similarly, the saleshop inspection reports were discussed with the managers in charge [HBCA, reels 859, 860, 863]. These reports were also submitted to the commissioner, who in a letter to the committee, explained how the identified shortcomings would be remedied. These letters and copies of the reports were then sent to the committee, which subsequently responded to the commissioner in terms of directions, or requests for more information.

To ensure knowledgeable appraisals, inspectors tended to be experienced post or district managers. However, there was a recognition that an inspector could not "independently" inspect posts under his own responsibility. Therefore, the inspectors tended to inspect posts for which they had no responsibility. Often, two inspectors were assigned to work together. One recommended combination was "an old fur trade officer such as Mr. Hardisty . . . [and] . . . Mr. Beaton who is an accountant and acquainted with the modern system of trading" [HBCA, reel 745].

The inspectors reported to the commissioner. In a letter to the committee in 1907, the commissioner described the inspection staff as consisting of three positions: a chief inspecting officer, an inspector of fur trade posts, and an inspector of saleshops [HBCA, reel 842]. The skill set of inspectors was described by the commissioner in recommending an employee for the job of fur post inspector:

> Mr. Tremayne's experience in various departments of the Company's service has been such as to give him a good general knowledge of detail, and while in charge of Lake Superior District he has shown himself to be economical and discretionary in his methods. That district, in view of the keen competition obtaining, has been a good training ground, and the knowledge of transportation matters acquired there and previously in British Columbia district are of value in the work which it is proposed to assign him. . . . On the other hand he is young and vigorous for traveling, and it is believed his visits to fur trade posts and districts would have a healthy influence, while his knowledge of general detail would render his services useful in the department when not so engaged [ibid.].

(2) *Accuracy and reliability of information*. Inspectors were concerned with the care with which the post books were maintained. Accurate and reliable books for trade goods, supplies, credit to aborigines, and fur inventories were deemed fundamental to the success of the Company.

(3) *Risk identified and minimized*. By approaching their work from the perspective of what was best for the Company, the inspectors identified issues regarding competition, fur availability, and other matters that would have a negative impact, and warned the commissioner.

(4) *External regulations and acceptable internal practices*. There were minimal external regulations for the HBC. However, the HBC had documented "Rules and Regulations" specifying the desired practices for both the fur posts [HBCA, reel 3M224] and the saleshops [HBCA, reel 863]. The committee and commissioner were explicit that the rules and regulations should be followed. Inspectors used these rules and regulations as a checklist for judging actual practices.

(5) *Satisfactory standards are met.* In addition to being used by the inspectors as a basis for judging actual practices, the rules and regulations noted above were used as the basis for expectations or standards. For example, item 42 in the 1887 "Rules and Regulations" specified that, "officers of districts shall visit all posts within their districts at least once a year" [HBCA, reel 3M224]. This was typical of the rules and regulations. The acceptable practice was for the officer in charge to visit the posts; the standard was that the visits must occur once a year.

(6) *Resources are used efficiently and economically*. The headings in Exhibit 2 were essentially a list of the resources used by a post. Moreover, fur posts and saleshops were allocated capital and evaluated with return on capital employed. Often inspectors did the return on capital employed calculations for the posts and saleshops, and made suggestions to improve profitability. In regard to the use of resources, the commissioner described the inspections as a means of exerting efficient control over operations [HBCA, reel 967]. Inspectors were also used in conjunction with the reorganization of districts and posts to systematically reduce expenses [HBCA, reels 820 and 821].

(7) *The organization's objectives are effectively achieved*. As a shareholder-owned, profit pursuing organization, the HBC's objectives emphasized the pursuit of profits and cost reductions. Inspections reflected these objectives. Inspectors were used when the commissioner and/or committee were contemplating structural changes, or when they had concerns about the profitability of a saleshop, post, or district.

A review of the actual inspection reports revealed that the managerial emphasis was blatant. The 1886 inspection reports for the Cumberland district provided examples [HBCA, reel 3M224]. The seven posts in the district were inspected, and a report on each was prepared and submitted to the commissioner. Each item from the scheme in Exhibit 2 was addressed, with the last section (h), containing suggestions for improvements which were cross referenced with earlier findings. Not every finding of deficiency led to a suggestion. The five suggestions for the Grand Rapids post are shown in Exhibit 3.

EXHIBIT 3
Suggestions by Inspecting Officers, 1886

1. Building at west-end of Portage should be maintained in case of opposition or any change in the Trade. It is stated that no Patent has been issued, but the Company's location should be secured. The ownership of the W. & WT. Co. is not known, it would do well to have this explained in case of emergency and to avoid trouble.

2 The exact cost landed of goods should be ascertained. Mr. McLean [the person in charge of the post] should make his own requisition (subject to the approval of the Officer in Charge) according to what he has in stock and the requirements of his trade; and after taking Inventory.

3. A Cash Book should be kept as well as an account of all expenses. The Profit of the Post should be ascertained at Cumberland. Mr. McLean appears to be anxious to be judged by results, of which at present he is ignorant.

4. An attempt might be made to increase the Fur Trade by giving assistance to Mr. McLean during the Winter - He being alone cannot look after it. Judiciously giving small debts to Fur Hunters in the early autumn might also help to increase the Returns especially if sufficient leather were at the Post.

5. The overstock should be struck off the Requisition at Cumberland. A list has been furnished to the Officer in Charge.

Source: HBCA [reel 3M224].

Another example of the managerial orientation of the inspection reports was revealed in a letter from the commissioner to the committee in 1899 [HBCA, reel 820]. The topic of the letter was the reorganization of five fur trade districts and their nineteen posts. In order to have an effective reorganization, the inspecting officer was asked by the commissioner to address questions relating to the amalgamation of districts with a view to more economical management; purchasing of furs and the use of valuation tariffs; aboriginal debts; and cash and trading tariffs. The inspecting officer's answers to the four questions were developed from an inspection of each post with similar criteria to that in Exhibit 2. Resulting reports were summarized into twenty pages of notes which were sent by the commissioner to the committee along with a typed letter from the inspecting officer to the commissioner with detailed, quantified answers to the four questions.

The HBC differentiated between inspectors and auditors. Inspectors were employees; auditors were not. Auditors verified the accuracy of accounts [HBCA, reel 822]. Part-time auditors were used from the late 1880s until 1911 to verify certain accounts [HBCA, reel 813]. The auditor at the Winnipeg office was the manager for the local Bank of Montreal branch, the HBC's bank. His duties in relation to the HBC were to verify the cash transactions, month-end statements, and inventories. The HBC also used the managers or the accountants at the Bank of Montreal branches in Vancouver, Victoria, and Montreal to verify account balances. These auditors reported to the committee in London and their duties were coordinated with the London auditor. In 1911 Marwick Mitchell & Co., a Scottish chartered accounting firm with offices in numerous U.S. cities as well as Montreal and Winnipeg, was hired to replace the part-time auditors. The HBC's London auditor had been employed by the committee from 1866 to "audit" the balance sheet and related financial statements [HBCA, reels 19 and 508].

This assessment of the HBC's inspection activities from 1871 to 1914 suggests that the inspections were comparable to modern definitions managerial internal audits.

CONCLUDING COMMENTS

Inspections were an integral part of the management of the HBC from 1871 until at least 1914. They were managerial in orientation, and as such they were an extension of the commissioner who did not have the time to visit and inspect posts and saleshops. Inspections were undertaken through the use of a checklist, specified by the commissioner. Financial inspection was included, but as a very secondary focus. More importantly, inspections by examining operating matters provided an alternative assessment to the financial trading accounts on how well the posts and saleshops were actually performing.

Although the development of the inspection function at the HBC appeared to be an isolated phenomenon, its genesis was not. Inspections had a comparable genesis to the development of managerial internal audits in early 20th century organizations described by Chandler [1962] and Williamson [1975]. The commonality was not complexity. The HBC was becoming less complex while Chandler [1962] and Williamson [1975] were dealing with increased complexity. The commonality — the use of abstract financial accounting data — meant that information on actual operations was needed for effective understanding. Thus, the inspection function was developed to compensate for the incompleteness of financial accounting information. If the commissioner could have observed his post and saleshop managers, he might not have needed inspectors. Alternatively, if the commissioner had continued to use the directing and monitoring mechanisms from the 1820 to 1860 (or Simpson) period, he might not have needed inspectors. However, by eliminating or de-emphasizing most of those directing and monitoring mechanisms in favor of instructing posts and saleshops directly with improved communications and with highly abstract trading accounts, the commissioner was required to use inspectors to truly understand the posts and saleshops. For a firm such as the HBC concerned with profits, activities had to be closely managed and controlled in order to maximize income generation.

In conclusion, the HBC inspections were developed not as a response to complexity as predicted by the accepted history of internal audit, but to compensate for the abstractness of the financial accounting data. Inspections, in other words, compensated for the low information content of the financial trading accounts. The research question that begs to be asked is, How did other organizations adjust to abstract financial accounting data? Was managerial internal audit evoked, or to compensate for the lack of information content were other controls introduced or expanded?

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