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Conceptual Aspects of Internal Control Evaluation

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IN PLANNING this program we were somewhat concerned that making a presentation on internal control to an audience of practicing CPAs might seem like "carrying coals to Newcastle." A similar concern was felt initially by the Committee on Auditing Procedure when this subject was placed on its agenda.

Our committee soon became convinced, however, that there are sufficient unresolved questions and problems in this area to justify reconsideration and issuance of a pronouncement. We hope that those in the audience today will feel the same way about this program.

Reconsideration of internal control by the committee was motivated largely by two reasons:

First, the length of time elapsed since the last pronouncement on this subject, coupled with several developments in business and in the profession in the meantime; second, some indication of a need to amplify and clarify concepts in the light of experience with the existing pronouncements.

Nevertheless, experience has demonstrated that the rationale and basic concepts comprehended in those pronouncements are fundamentally sound, and consequently no radical departures will be proposed on this program, despite the reference to "new directions" in the program brochure.

Some of the developments in business and in the profession in the last several years and their relation to internal control will be mentioned briefly.

The increasing trend for CPAs to provide management advisory or consulting services involving the review, evaluation, and improvement of management information systems increases the need for clearly distinguishing between these extended services and those required for compliance with the auditing standard relating to internal control.

The rapidly increasing use of computers for processing accounting and other business information has introduced additional problems in reviewing and evaluating internal control for audit purposes, as well as in making the distinction between audit services and extended services.

Closely related to the increasing use of computers is the trend toward integration of accounting information required for financial and other operating purposes into coordinated management information systems. This development increases the need to identify clearly the elements of the total system that are comprehended in the auditing standard concerning internal control.

These developments and distinctions are important not only for the purpose of defining the nature and scope of the auditor's review and evaluation of internal control but also in clarifying his reports thereon. This need is accentuated by the increasing requests for such reports for use by management or by regulatory agencies and sometimes for inclusion in published reports.

The need for clarification of certain aspects of the existing pronouncement will be presented following a brief discussion of the purposes of the auditor's study and evaluation of internal control and of the present definition and classification.

PURPOSES

The primary purpose of the auditor's study and evaluation of internal control, as expressed in the auditing standard previously referred to, is to establish a basis for reliance thereon in determining the extent of audit tests to be applied in his examination of the financial statements.

A secondary, but nevertheless important, purpose is to provide constructive suggestions to clients. This purpose is recognized in the following excerpt from the comments in Statement No. 33 with respect to the auditing standard concerning internal control:

> As a by-product of this study and evaluation, the independent auditor is frequently able to offer constructive suggestions to his client on ways in which internal control may be improved.

Although auditors are interested in both of the foregoing purposes, it is important to recognize an essential difference between them. The study and evaluation for audit purposes is a professional requirement, while constructive suggestions to clients are desirable but nevertheless discretionary. Consequently, the study and evaluation for audit purposes should be adequate for each year, while the attention given to constructive suggestions may properly vary from client to client or from year to year for a particular client.

PRESENT DEFINITION AND CLASSIFICATION

The essence of the present definition of internal control is included in the following excerpts from Statement No. 33:

> 5. In the broad sense, internal control includes . . . controls which may be characterized as either accounting or administrative, as follows:
>
> a. Accounting controls comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, safeguarding of assets and the reliability of the financial records.
>
> 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.

The foregoing subdivision of internal control into accounting controls and administrative controls was made in Statement No. 29 primarily for the purpose of clarifying the scope of the study required under generally accepted auditing standards, in order to facilitate the distinction between these requirements and other purposes. The committee's conclusions in that respect, as codified in Statement 33, were as follows:

> 21. The independent auditor is primarily concerned with the accounting controls. . . . If the independent auditor believes, however, that certain administrative controls may have an important bearing on the reliability of the financial records, he should consider the need for evaluating such controls.

NEED FOR CLARIFICATION

The present committee believes that clarification of the existing definition of accounting controls is desirable because of possible differences in interpretation with respect to the two key elements comprehended in it: the safeguarding of assets and the reliability of financial records.

Safeguarding of Assets

The definition of "safeguard" that appears relevant in the context of the present definition is "a means of protection against something undesirable." Use of this definition conceivably could lead to a broad interpretation that the protection of existing assets and the acquisition of additional assets is the primary function of management, and therefore that any procedures or records entering into management's decision-making processes are comprehended in this element of the definition of accounting controls. Under this concept, for example, a management decision to sell a product at a price which proves to be unprofitable might be regarded as a failure to protect existing assets, and therefore as evidence of inadequate accounting control. The same interpretation might be applied to a decision to incur expenditures for equipment which proves to be unnecessary or inefficient, for materials which prove to be unsatisfactory in production, for merchandise which proves to be unsaleable, for research which proves to be unproductive, for advertising which proves to be ineffective, and to similar management decisions.

A second possible interpretation is that safeguarding of assets refers only to protection against loss arising from intentional or unintentional errors in processing transactions and handling the related assets. Errors of the latter type include understatement of sales through failure to prepare invoices, or through errors in pricing or computation; overpayments to vendors or employees arising from errors involving quantities of materials or services, prices or rates, or computations; and physical loss of assets such as cash, securities, or inventory. In some situations errors of this type might also include improper allocations of certain costs, which would result in failure to recover these costs from customers.

A third possible interpretation is that safeguarding of assets refers only to protection against loss arising from intentional errors. This type of error includes defalcations and similar irregularities, the latter including falsification of records for the purpose of causing erroneous payments of commissions, profit-sharing bonuses, royalties, and similar payments based on the recording of other transactions.

Reliability of Financial Records

Possible differences in interpretation concerning the "reliability of financial records" arise from the different purposes for which the financial records may be used. The two broad uses are for internal management purposes and external reporting purposes. One interpretation would extend the scope of accounting control to include reliability of the financial records for both of these purposes, while another would restrict it to external reporting purposes only.

To illustrate the foregoing distinction, the degree and accuracy of classifications, details, and allocations required to provide reliability of records for such management purposes as establishing sales policies and prices, estimating future costs, and measuring performance by divisions, products, or other lines of responsibility, ordinarily exceeds that required to provide reliability for external reporting purposes.

REVISED DEFINITION

The committee believes the present definition of accounting control extends only to the safeguarding of assets against loss from unintentional or intentional errors or irregularities, and to the reliability of financial records for external reporting purposes. It believes also that a revised definition expressed in relation to the functions involved in the flow of transactions is desirable to clarify the understanding and application of the second standard of field work.

Transactions are the basic components of business operations, and therefore are the primary subject matter of business control. The primary functions involved in the flow of transactions and related assets include: the authorization, execution, and recording of transactions, and the accountability for resulting assets.

As indicated earlier, the committee believes the present definitions of administrative and accounting controls can be clarified by redefining them in relation to these functions as follows:

Administrative controls include but are not limited to the plan of organization and the procedures and records that are concerned with the decision processes leading to management's authorization of transactions. Such authorization is a management function directly associated with the responsibility for achieving the objectives of the organization, and is the starting point for establishing accounting control of transactions.

Accounting controls comprise the plan of organization and the procedures and records designed to provide reasonable assurance that:

1. Transactions are executed only in accordance with management's authorization.

2. Transactions are recorded as necessary (a) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (b) to recognize and maintain accountability for assets.
3. The recorded accountability for assets is compared with the existing assets at reasonable intervals.

The foregoing definitions are not necessarily mutually exclusive, because some of the procedures and records comprehended in accounting controls may also be involved in management's decision processes. This possible overlapping area, however, is not critical for the purpose of the proposed statement since it is concerned more with clarifying the outer boundary of accounting control than the inner boundary of administrative control.

In comparing the definition of accounting control in Statement 33 with the proposed revised definition, the committee believes that "safeguarding of assets" referred to the execution of transactions in accordance with management's authorization and the accountability for assets acquired, while the "reliability of the financial records" referred to their reliability for the purposes of maintaining accountability for assets and preparing financial statements in conformity with generally accepted accounting principles or other applicable criteria.

BASIC CONCEPTS

Certain basic concepts are implicit in the proposed definition of accounting control, which are applicable generally, but the organizational and procedural requirements for applying them may differ considerably from case to case because of the variety of circumstances involved. Therefore, it is not feasible to discuss these requirements in detail on this program.

Reasonable Assurance

The definition requires reasonable, but not absolute, assurance that the objectives comprehended in it will be accomplished. This recognizes that the cost of accounting control should be justified by the benefits derived. The benefits consist of reductions in the risk of loss from errors or irregularities involving the financial statements or the accountability for assets. Although the benefits are difficult to measure, the cost-benefit relationship is the conceptual criterion that should be applied in designing and evaluating a system of internal accounting control.

Incompatible Functions

Incompatible functions for accounting control purposes are those that place any person in a position both to perpetrate and to conceal errors or irregularities in the normal course of his duties. Generally, anyone who prepares records or has custody of assets is in a position to perpetrate errors or irregularities. Accordingly, accounting control necessarily depends largely on the elimination of opportunities for concealment. This, in turn, requires that procedures designed to detect errors and irregularities be performed by persons other than those who are in a position to perpetrate them—i.e., by persons having no incompatible functions.

Execution of Transactions

Obtaining assurance that transactions are executed as authorized requires that authorizations be examined and compared independently with the documents evidencing the transactions. The purpose of the examination of authorizations is to obtain evidence that they were issued by persons acting within the scope of their authority. The purpose of the comparison is to obtain evidence that the transactions conform with the terms of the authorization.

Recording of Transactions

The objective of accounting control with respect to the recording of transactions requires that they be recorded at the amounts and in the accounting periods in which they were executed, and be classified in appropriate accounts.

Obtaining assurance that these objectives are achieved depends partially on the competence and integrity of personnel, the independence of the assigned functions, and the completeness and understanding of the prescribed procedures. Although these factors are important, their contribution to accounting control nevertheless is to provide an environment conducive to proper recording, rather than to provide assurance that it has occurred.

The possibilities for obtaining assurance that transactions have been recorded depend largely on the availability of some independent source of information that will provide an indication that the transactions have occurred. These possibilities vary widely with the nature of the transactions, and time does not permit presentation of examples illustrating this concept.

Comparison of Recorded Accountability with Assets

The purpose of the comparison of recorded accountability for assets is to determine whether the actual assets agree with the recorded accountability, and consequently it is closely related to the foregoing discussion concerning the recording of transactions. Typical examples of this comparison include cash and securities counts, bank reconciliations, and physical inventories.

If the comparison reveals that the assets do not agree with the recorded accountability this is evidence of unrecorded transactions. The converse, however, does not necessarily follow. For example, agreement of a cash count with the recorded balance is not evidence that all cash received has been recorded. This illustrates an unavoidable distinction between fiduciary and recorded accountability: The former arises immediately upon acquisition of an asset, while the latter cannot be recognized until the initial record of the transactions is prepared.

The frequency with which such comparison should be made depends on the nature and amount of the assets involved and the cost of making the comparison. For example, it may be reasonable to count cash daily but not reasonable to take a physical inventory at that interval. However, a daily inventory of products in the custody of route salesmen, for example, may be practicable as a means of determining their accountability for sale. Similarly, the value and vulnerability of some products may make frequent complete inventories worth while.

Limitations

There are certain limitations on the potential effectiveness of accounting control that should be recognized in any consideration of the subject. In the performance of most control procedures there are possibilities for errors arising from such causes as misunderstanding of instructions, mistakes of judgment, and personal carelessness, distraction, or fatigue. Furthermore, procedures whose effectiveness depends on segregation of duties obviously can be circumvented by collusion. Similarly, procedures designed to assure the execution and recording of transactions in accordance with management's authorizations may be ineffective against either errors or irregularities perpetrated by management with respect to transactions or to the estimates and judgments required in the preparation of financial statements.

STUDY OF SYSTEM

Scope of Study

As redefined in the proposed statement, accounting controls are within the scope of the study and evaluation of internal control required by generally accepted auditing standards, while administrative controls are not.

The study to be made as the basis for the evaluation of internal control includes two phases as indicated in the following excerpt from Statement No. 33:

> Adequate evaluation of a system of internal control requires (1) knowledge and understanding of the procedures and methods prescribed and (2) a reasonable degree of assurance that they are in use and are operating as planned. (Numerals added)

These two phases of the study are referred to hereinafter as the review of the system and tests of compliance, respectively.

Review of System

The review of the system is primarily a process of obtaining and recording information about the organization and procedures prescribed to serve as the basis for the tests of compliance and for the evaluation. The information required for this purpose ordinarily is obtained through discussion with supervisory client personnel and reference to documentation such as procedure manuals, job descriptions, flow charts, and decision tables.

The information obtained from the review of the system may be recorded by the auditor in the form of answers to a questionnaire, narrative memoranda, flow charts, decision tables, or any other form that suits the auditor's needs or personal preferences.

In order to clarify their understanding of information obtained from such sources, some auditors follow the practice of tracing one or a few of the different types of transactions involved through the related documents and records maintained. While this practice may be useful for the purpose indicated, it should *not* be confused with tests of compliance.

Tests of Compliance

The nature of internal control procedures and of the available evidence of compliance necessarily determines the nature of the tests of compliance and also influence the extent of such tests.

Nature of Tests

Adequate accounting control requires not only that certain procedures be performed, but that they be performed independently. Tests of compliance, therefore, are concerned primarily with two questions: whether the necessary procedures were performed and, if so, by whom.

Some aspects of accounting control require the performance of certain control procedures that are not necessarily required for the execution of transactions. This class of procedures includes the approval of documents evidencing external transactions and the preparation, checking, or approval of internal documents such as accounting records, reconciliations, and reports. Tests as to whether, and by whom, such procedures are performed require observation of the related documents to obtain evidence of compliance in the form of signatures, initials, and audit stamps, and the like.

A second aspect of accounting control requires a segregation of duties so that certain incompatible procedures are not performed by the same persons. The performance of some of these procedures is largely self-evident from the operation of the business or the existence of its essential records; consequently, tests of compliance with such procedures are primarily for the purpose of determining whether they were performed by persons having no incompatible duties. Examples of this class of procedures may include the receiving, depositing, and disbursing of cash, the recording of transactions, and the posting of customers' accounts. Since such procedures frequently leave no audit trail of documentary evidence as to who performed them, tests of compliance in these situations necessarily are limited to corroborative inquiries of different personnel and observation of office routines to supplement the information obtained during the initial review of the system. While reconciliations, confirmations, or other audit tests performed in accordance with the auditing standard relating to evidential matter may substantiate the accuracy of the underlying records, these tests frequently provide no affirmative evidence of the necessary segregation of duties since the records may be accurate even though maintained by someone having incompatible duties.

The foregoing distinction as to the nature of control procedures and available evidence of compliance also influences the extent of tests of compliance.

Extent of Tests

As indicated earlier, the purpose of tests of compliance with accounting control procedures is to provide "a reasonable degree of assurance that they are in use and are operating as planned." What constitutes a "reasonable" degree of assurance is a matter of auditing judgment. The "degree of assurance," however, is necessarily a function of the nature and extent of the tests and of the results obtained.

As to accounting control procedures that leave an audit trail of documentary evidence of compliance, the committee believes that tests of compliance should be spread throughout the year or other audit period. For this type of test, statistical sampling is a practicable means for expressing in quantitative terms the auditor's judgment as to reasonableness, and for determining the extent of tests and evaluating the results on that basis. As indicated by earlier pronouncements of the committee, the use of statistical sampling is compatible with, but not required by, generally accepted auditing standards. This topic will be discussed further by the next speaker.

As to accounting control procedures that depend primarily on segregation of duties and leave no audit trail, the committee believes that tests of compliance may appropriately be confined to the periods during which the auditor is present on the client's premises in conducting other phases of his audit.

EVALUATION OF SYSTEM

The auditor's evaluation of the system of accounting control and his tests of compliance should, of course, be related to the purposes of his evaluation.

From the viewpoint of management, the purposes of accounting control are stated in the definitions given previously. These purposes apply equally, of course, to the independent auditor, but they have been stated somewhat differently and more directly as follows:

> A function of internal control, from the viewpoint of the independent auditor, is to provide assurance that errors and irregularities may be discovered with reasonable promptness, thus assuring the reliability and integrity of the financial records. The independent auditor's review of the system of internal control assists him in determining other auditing procedures appropriate to the formulation of an opinion on the fairness of the financial statements.

A suggested general approach to the auditor's evaluation of accounting control, which focuses directly on the purpose of preventing or detecting errors and irregularities, involves the following steps:

1. Analyze the types of errors and irregularities that could occur in processing the various kinds of transactions and handling the related assets.
2. Determine the accounting control procedures that should prevent or detect such errors and irregularities.
3. Determine whether the necessary procedures are prescribed and being followed satisfactorily.
4. Evaluate any weaknesses—i.e., types of errors and irregularities not covered by existing controls—to determine their effect on (a) the nature, timing, or extent of auditing procedures to be applied, and (b) suggestions to be made to the client.

This suggested approach emphasizes the possibilities for, and controls against, particular types of errors and irregularities concerning particular classes of transactions and related assets. Controls and weaknesses affecting different classes of transactions are not offsetting in their effect. For example, weaknesses in cash receipts procedures are not mitigated by controls in cash disbursement procedures; similarly, weaknesses in billing procedures are not mitigated by controls in collection procedures. For this reason, evaluation of accounting control should be made with reference to the procedures pertaining to particular classes of transactions or related assets; unless equally applicable to all procedures being evaluated, generalized or over-all evaluations are not likely to be useful for auditors or others.

The auditor's final evaluation of internal control for his primary purpose should be in the form of conclusions as to (a) whether the prescribed procedures are adequate, subject to the inherent limitations discussed earlier, to prevent or detect with reasonable promptness material errors and irregularities and (b) whether compliance with such procedures is satisfactory.

CORRELATION WITH OTHER AUDITING PROCEDURES

Since the purpose of the evaluation required by the second auditing standard of field work is to provide a basis "for the determination of the resultant extent of the tests to which auditing procedures are to be restricted," it is clear that its ultimate purpose is to contribute to the "reasonable basis for an opinion" comprehended in the third standard, which is quoted below:

> Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

The evidential matter required by the third standard is obtained generally through the auditor's (a) substantive tests of details of transactions and balances, and (b) analytic review of significant ratios and trends and resulting investigation of unusual fluctuations and questionable items.

The committee believes it is desirable to make clear that the second standard does not contemplate that the auditor should place complete reliance on internal control to the exclusion of other auditing procedures with respect to material accounts in the financial statements.

In considering the more difficult question as to the extent of restriction contemplated in the second and third standards, the committee believes the following excerpts from a Special Report issued by the AICPA Committee on Statistical Sampling in 1964 provides a useful conceptual analysis of the intricate relationship between these standards:

> . . . the ultimate risk against which the auditor and those who rely on his opinion require reasonable protection is a combination of two separate risks. The first of these is that material errors will occur in the accounting process by which the financial statements are developed. The

> second is that any material errors that occur will not be detected in the auditor's examination.
>
> The auditor relies on internal control to reduce the first risk, and on his tests of details and his other auditing procedures to reduce the second. The relative weight to be given to the respective sources of reliance . . . are matters for the auditor's judgment in the circumstances.
>
> The second standard of field work recognizes that the extent of tests required to constitute sufficient evidential matters under the third standard should vary inversely with the auditor's reliance on internal control. These standards taken together imply that the combination of the auditor's reliance on internal control and on his auditing procedures should provide a reasonable basis for his opinion in all cases, although the portion of reliance derived from the respective sources may properly vary between cases.

Statistical sampling provides a means for expressing in quantitative terms the auditor's judgment as to the reliance to be placed on his substantive tests of details of transaction and balances, and for determining the extent of such tests and evaluating the results on that basis. As mentioned earlier, however, the use of statistical sampling is compatible with, but not required by, generally accepted auditing standards.

The committee will be giving further consideration to the difficult but important question as to the degree of reliance that may be placed on internal control in determining the extent of other audit tests. Whether any consensus can be reached on useful guidelines expressed in terms of statistical sampling or on any other basis remains to be determined.

Any constructive suggestions on this question or on other aspects of the proposed statement on internal control will be welcomed by the committee.