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Opportunities for the Coördination of the Activities of the Internal Auditor and the Independent Public Accountant

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ANY DISCUSSION of opportunities for coördination of the activities of the internal auditor and the independent Certified Public Accountant should commence with a clear definition of their objectives and responsibilities in the area of business management. For the rest of this paper I shall refer to the independent Certified Public Accountant simply as "independent accountant" and shall restrict the discussion to his rôle in the examination of financial statements. His activities in the fields of taxes and management advisory services are not germane to this discussion, except as may be noted later.

OBJECTIVES AND RESPONSIBILITIES

Both the independent accountant and the internal auditor make audits or examinations of the financial data of a business enterprise. Their objectives, however, are different. The Codification of Statements on Auditing Procedures published by the American Institute of Certified Public Accountants has this to say about the purpose of the examination by the independent accountant:

The primary purpose of an examination of financial statements by an independent Certified Public Accountant is to enable him to express an opinion as to the fairness of the statements, their compliance with generally accepted accounting principles, and the consistency of the application of those principles with that of the preceding period.

His examination must be carried out in accordance with well-defined guidelines and standards prescribed by the accounting profession. The financial statements on which the independent accountant expresses his opinion may be used for reporting to shareholders, granting of credit, reporting to the Securities and Exchange Commission or other regulatory bodies, or for any number of other business purposes.

The purpose of an examination by the internal auditor is to assure

management that the established control policies and procedures of the enterprise are being followed and adhered to, that they are being interpreted properly, and that the policies and procedures have not become obsolete or inadequate. The scope of his examination and the methods used will vary, depending on the accounting system and organizational structure of the specific enterprise and the limits placed by management on his authority.

The independent accountant, of course, is also deeply interested in the system of internal control. As part of his examination of financial statements, he investigates and evaluates its adequacy. He bases the extent of his tests and checks of accounting records and transactions upon its effectiveness.

The system of internal control, of which the function of internal audit is a part, is, therefore, of common interest to the independent accountant and to the internal auditor. Because of its importance to both groups it may be well to quote, in part, from the Special Report by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants on Internal Control.

Management has the responsibility for devising, installing and currently supervising a system of internal control adequate to: (1) safeguard the assets of an organization; (2) check the accuracy and reliability of accounting data; (3) promote operational efficiency; and (4) encourage adherence to prescribed managerial policies; and, for these purposes, to provide an appropriate plan of organization; an adequate system of authorization and record procedures; sound practices, and lastly, personnel of appropriate number and capabilities.

Effective internal control is so pertinent to the question of the reliability of financial data and so fundamental to a proper discharge of management's total responsibility as to require that management be prepared to demonstrate the steps taken to attain it. A chart of accounts testifies to the adequacy of a plan of accounts, and a properly prepared procedures manual provides a standard with which the actual procedures in use may be compared to detect departures which may afford opportunities for irregularities whether fraudulently conceived or otherwise.

The responsibility of management does not end with the installation of control procedures initially deemed necessary. A system of internal control must be under constant surveillance to determine (1) that prescribed policies are being interpreted properly

and are being carried out, (2) that changes in operating conditions have not made the procedures cumbersome, obsolete or inadequate, and (3) that where breakdowns in the system appear, effective corrective measures are taken promptly. Any system regardless of its fundamental soundness, will deteriorate rapidly if not reviewed periodically. Laxity becomes contagious and, if permitted to spread, will soon render any measures of control useless.

Internal auditing is the tool that management uses in discharging its responsibilities outlined in the preceding paragraph.

The common interest of the independent accountant and the internal auditor is further focused in the function of checking the accuracy and reliability of accounting data. This is not to say that the independent accountant is not interested in controls for safeguarding of assets or for promoting operational efficiency. He is; and his interest in these areas may well lead to his rendering of additional services outside the examination of financial statements. However, since his ultimate objective is to form and express an opinion on the financial statements, he is more directly interested in the accuracy and reliability of the accounting data the financial statements summarize.

AREAS FOR COÖPERATIVE EFFORT

With the dissimilarity of objectives, are there opportunities for coördinating the efforts of the independent accountant and of the internal auditor? The answer to this will depend on the effectiveness of the system of internal control, the attitude of the independent accountant, the qualifications of the internal audit staff, their availability, and more important, the organization of the enterprise. It should be noted that the discussion concerns the coördinating of two separate programs and activities insofar as they may cover common ground. Because of the dissimilarity in objectives, a complete joint audit program is not considered practical.

As mentioned earlier, the independent accountant views the internal audit function as a part of the system of internal control. As such, he needs to satisfy himself that the internal audit staff is well organized, qualified, and well trained, and that it approaches its work objectively. The matter last mentioned is important. The independent accountant, for example, may not feel the internal audit group will do an objective evaluation of stores control if he knows that it devised the stores procedures and methods. Incidentally, manage-

ment should take the same attitude and should keep the internal audit and procedures and methods design functions separated.

The areas where the two groups can cooperate and coordinate their activities include but are not limited to (1) audit of individual limited accounting units, such as branches, plants, warehouses, and subsidiaries, (2) tests of transactions, such as sales, purchases, cash receipts and disbursements, payrolls, (3) individual account balance verifications, such as cash, accounts receivable, inventories, plant, accounts payable. In addition, the independent accountant should review the entire program of examinations carried out independently by the internal auditor during the year to determine the areas where he can curtail his examination in light of the work done.

APPROACH TO PROBLEM OF COÖRDINATION

I should like to discuss briefly our approach to this problem in connection with the annual audit of one of our clients. The company is organized along divisional lines. Each division operates a number of plants and, for accounting purposes, is headed by a controller. It also controls a number of both domestic and foreign subsidiaries whose accounts are consolidated with those of the parent in the financial statements. The internal audit group is headed by a trained auditor who has been with the company for many years and who is fully acquainted with the company's operations. Under him he has a number of trained and qualified staff auditors. He reports to the controller of the company as do the divisional controllers.

Each year we meet with the chief internal auditor and agree on the plant examinations that will be made by us and those that will be made by his staff. We generally reserve to ourselves the examination of key plants but we invite the internal auditors to time their examination with ours in order to eliminate duplication of work. In these instances the internal auditor assigned to the plant is placed under our direction in carrying out those phases of the audit in which we are interested. He uses our programs and turns his work papers over to us. This may include examination of payrolls, reconciliation of local bank accounts, the reconciliation of physical inventory counts with the books. After he has completed his work under our direction he then may carry out certain other auditing procedures as required by the internal audit program.

In smaller plants their examination is rotated between us and the internal audit group.

Because the terms of our engagement require that we express our opinion on the financial statements of each individual subsidiary, each subsidiary is examined by us. Where this is not required of the independent accountants, it would be possible, and quite reasonable, also to rotate the examination of the less important subsidiaries so long as the aggregate of the assets and sales or revenues of the subsidiaries not examined was not material in relation to the consolidated assets and sales or revenues.

In the observation of physical inventories we coördinate our work with that of the internal auditors so as to utilize our combined manpower for the widest and most effective coverage.

We use the statistical sampling method in selecting accounts receivable for circularization. We review and note all replies denoting differences and then turn the accounts over to the internal audit group to run down and clear up reported differences to our satisfaction. This we have found to be a most satisfactory arrangement because in addition to saving us time in running down differences, it gives the internal audit staff an insight into factors causing the differences and affords them the needed information to institute corrective action.

We plan and jointly execute cash and security counts. Generally, the reconciliation of imprest fund bank accounts—such as dividends, payrolls, and claims accounts—is done by the internal auditors and reviewed by us.

We are given a copy of each report of the internal auditors. These reports are carefully read and matters of particular interest to us noted to be followed up and discussed. Their findings are given full consideration in our evaluation of the effectiveness of the system of internal control and in determination of the extent of our test checks.

Similarly, any deficiencies or breakdowns in internal control noted by us are reported to the financial vice president and to the controller. The internal audit group is instructed to investigate them and institute corrective action. During one examination our tests indicated too much was being lost in cash discounts because of late processing of accounts payable vouchers. The internal auditing department was instructed to investigate and report. Their investigation showed the accounts payable department was not adequately staffed to process the volume of vouchers within the discount period. Volume had increased materially since the previous year. Two clerks were added at a cost of \$800 a month. Discount losses were estimated at \$2,000 a month—a saving of \$1,200 monthly.

As for a utility company, I can envisage coöperation with internal auditors in the area of testing and checking property additions and retirements, testing of revenues, circularization of customer accounts, balancing and reconciliation of customers deposits and bank accounts, testing of payrolls, physical observation of stores inventory, and testing of stores receipts and issues. The full extent of the coöperation of the internal auditor and the independent accountant, here again, will depend on the size and organization of the public utility company.

SURVEY OF 1956

The Research Committee of the Chicago Chapter of The Institute of Internal Auditors conducted a survey in 1956 of the coöperation between independent accountants and internal auditors during annual audits. The survey was conducted by submitting a questionnaire to each member of the chapter whose company had an annual audit. Sixty-six companies responded. I have had certain tabulations from the survey reproduced and these have been distributed to you. The first is a tabulation of answers to ten questions contained in the questionnaire. The second tabulation shows the percentage of "yes" answers to the various activities mentioned under question 2 in the questionnaire, classified by size of business organizations. The third table shows all questions that showed definite trends when classified according to length of time during which the internal auditing staffs had been functioning.

The tabulations show that there is a considerable degree of coöperation during annual audits between the independent accountants and the internal auditors. Interestingly, they also indicate that in the bigger companies the coöperation of the internal auditors tends to be in the area of verification of certain accounts or transactions independently, whereas in the smaller companies the internal auditors' coöperation is more in the line of assisting the independent accountant. Also, the older internal audit departments seem to do a greater degree of independent verification of certain accounts and transactions and in assuming complete charge of audits of branches of subsidiaries than do the more recently established ones.

SUMMARY

In conclusion, I may summarize by saying that the independent accountant and the internal auditor make their examinations for different purposes and with different objectives. They do have a common

interest in the area of testing the reliability and checking the accuracy of accounting data. This affords an opportunity for coördination of their work in the interest of efficiency and economy. The extent to which the independent accountant will be willing to accept the work of the internal auditor in this area will depend on his evaluation of the system of internal control, the qualifications and effectiveness of the audit staff, and his judgment of the various other factors to be considered. There can be no supplanting of the one by the other. Each function is essential and is necessary for the successful management of an enterprise.

TABULATION OF ANSWERS RECEIVED TO A QUESTIONNAIRE
ON COÖPERATION OF INTERNAL AUDITORS AND
PUBLIC ACCOUNTANTS DURING ANNUAL AUDITS
COMPILED BY THE CHICAGO CHAPTER OF THE INSTITUTE
OF INTERNAL AUDITORS

	<u>Yes</u>	<u>No</u>	<u>Other</u>
1. Are there conferences between representatives of the public accountants and the internal auditing staff of your company for the purpose of discussing any of the following topics?			
a. Coöperation during the annual audit	54	10	2
b. Planning future activities of the Internal Auditing Department	37	29	0
c. Assignment of responsibilities between the public accountants and internal auditors in connection with the annual audit for the examination of branches, subsidiaries, warehouses, district sales offices, etc.	24	35	7
2. In connection with the annual audit by the public accountants, does the coöperation of the Internal Auditing Department of your company include any of the following activities?			
a. Preparing schedules and analyses	38	26	2
b. Verification of certain accounts independently	30	34	2
c. Expediting the audit by obtaining documents and information	37	27	2
d. Making cash and security counts independently	30	33	3
e. Making available the audit reports of the internal auditing department	63	2	1
f. Introduction of the public accountants to executives	28	32	6
3. Do all work papers, schedules, counts and computations prepared by the internal auditors in connection with the annual audit become part of the public accountant's work file?	20	37	9
4. Does your company take an inventory (cycle or annual)?	59	1	6
5. Does the internal audit staff of your company participate in the observation or testing of the inventory?	55	5	6
6. Does the internal audit staff of your company supplant the public accountants in the observation and/or testing of inventories at any of the following locations?			
a. Home Office	15	27	24
b. Branch Plants	26	25	15
c. Sales Offices	14	21	31
d. Subsidiaries	16	23	27
e. Warehouses	22	19	25
f. Vendors' or consignees' locations	14	19	33

7. Are pricing tests made by the internal audit staff of your company accepted by the public accountants without further verification on their part in cases where the internal auditors exclusively observed the taking of the annual inventory? 10 24 32
8. Does the internal auditing staff of your company assume complete charge of the audit of any of the branches or subsidiaries in connection with the annual audit? 17 34 15
9. If the answer to question 8, above, is "Yes" answer the following:
 - a. Do the internal auditors follow an audit program furnished by the public accountants? 3 14 17
 - b. Are audits of all locations alternated annually? 8 8 18
 - c. Are only audits of certain locations alternated periodically? .. 5 9 20
 - d. Are annual audits of certain branches or subsidiaries always the responsibility of the internal auditors? 8 8 18
10. Do your public accountants make their work papers available to the internal audit staff?
 - a. Full access 28 18 20
 - b. Limited access 20 11 35
 - c. No access 4 12 50

**TABULATION SHOWING PER CENT OF "YES" ANSWERS
TO QUESTION 2 IN THE QUESTIONNAIRE
CLASSIFIED BY SIZE OF BUSINESS ORGANIZATION**

<u>Size of Business Organization</u>	<u>Less than 2,000 Employees</u>	<u>2,000 to 5,000 Employees</u>	<u>5,000 to 10,000 Employees</u>	<u>10,000 to 20,000 Employees</u>
Preparing schedules and analyses	80%	65%	62%	48%
Verification of certain accounts independently	30	28	50	70
Expediting the audit by obtaining documents and information	70	72	50	48
Making cash and security counts independently	40	47	33	61
Making available the audit reports of the Internal Auditing Department	90	94	100	100
Introduction of the public accountants to executives	50	63	36	91

**TABULATION OF "YES" ANSWERS TO QUESTIONS
SHOWING DEFINITE TRENDS CLASSIFIED ACCORDING
TO AGE-YEARS OF INTERNAL AUDIT DEPARTMENT**

<u>Length of Time Internal Audit Department has been Functioning</u>	<u>Less than 5 Years</u>	<u>5 Years to 10 Years</u>	<u>10 Years to 20 Years</u>	<u>More than 20 Years</u>
Verification of certain accounts independently	18%	47%	46%	77%
Making cash and security counts independently	31	47	54	59
Assuming complete charge of the audit of any of the branches or subsidiaries in connection with the annual audit	17	25	27	50

