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Reliance of Independent Public Accountants on the Work of the Internal Auditor

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THE AUTHORITY for the public accountant to rely on the work of the internal auditor has been well established. *Generally Accepted Auditing Standards,* published by the American Institute of Certified Public Accountants, states that as part of the field work of the public accountant "there is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

The standard short-form report rendered by the public accountant contains a scope paragraph stating that the "examination was made in accordance with generally accepted auditing stndards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances." In considering "the circumstances" surrounding an engagement the public accountant is particularly concerned with the system of internal control maintained by the client.

A good system of internal control embraces many types of controls, all of which are important. Accounting controls, budgetary controls, fiscal controls, and production controls are all just as important as internal auditing. However, internal audit is particularly important to the public accountant because it is devoted to policing the over-all system of internal control. Although the responsibility of the internal auditor extends beyond the policing of the system of internal control,[1] it is this function that is of particular interest to the public accountant because his reliance on the system of internal control is directly affected by the effectiveness of the system of internal audit in assuring him, as well as the company's management, that an effective system of internal control is being maintained consistently in accordance with management's directives.

[1] See *Statement of Responsibilities of the Internal Auditor,* Institute of Internal Auditors, 1957.

DETERMINING WHETHER THE INTERNAL AUDIT SYSTEM IS EFFECTIVE

The public accountant must evaluate the system of internal audit in the same way that he evaluates other aspects of the system of internal control. He must be satisfied that all of the requirements for effective internal auditing have been met. The internal auditor and his staff must be suited by training and temperament for their work. Audit programs must be well planned and executed. Reports must be clear and conclusive, and criticisms contained therein should be followed up promptly by management to ensure that corrective action is taken. Above all, the internal auditor must report to a highly placed official and enjoy the support of management generally.

If the public accountant is to rely on the internal auditor's work he must have confidence in the internal auditor. A first step in gaining this confidence is to learn the qualifications of the internal auditor. The internal auditor must not only have a knowledge of accounting and auditing techniques, but must also have a clear understanding of management's responsibility for the company's operations and the stewardship of its assets. In other words, he must share management's viewpoint in his approach to his job. He must have imagination and perseverance in order to appreciate fully the significance of his findings and to follow them through to fitting conclusions. Finally, he must have the type of personality that inspires the confidence and support of management and the coöperation of executives and other employees whom he meets during the course of his examination.

The public accountant can determine whether the internal auditor has these qualifications, first, by inquiry concerning his training and previous experience; secondly, through his contacts with the internal auditor during the course of his work; thirdly, by reference to the internal auditor's work papers and reports; and finally, through his association with others who come into contact with the internal auditor and who are affected by his work.

PLANNING

Careful planning is essential to effective internal auditing. Programs must be properly designed to ascertain whether prescribed procedures and policies are being consistently observed and whether adequate controls are thereby provided. There must be proper planning for the use of available staff time in order to ensure that all areas that should be covered are subject to regular audits in accordance with a prescribed program. The internal auditor must often make previous arrangements with operating units if he is to cover certain procedures most effectively, such as physical inventory observation. On the other hand, plans must be made for unannounced examinations with respect to other procedures, such as cash and security counts. Finally, adequate briefing of the audit staff prior to the commencement of each examination is an important part of good planning.

Although the public accountant will make an initial review at the commencement of his work in order to disclose obvious shortcomings in the internal audit program, he cannot conclusively determine the adequacy of the internal auditor's program until he has had an opportunity to study it in detail and relate its scope to the system of internal control. He will therefore continuously appraise the internal auditor's program throughout the course of his own work.

EXECUTION OF THE AUDIT FUNCTION

The public accountant expects that the work of the internal auditor will be carried out in a professional manner. He must be satisfied that the assistants assigned to each section of the internal audit program are capable of carrying out their assignments and are properly supervised. In particular he must be satisfied that internal auditors assigned to the work are capable of recognizing weaknesses in internal control as well as deviations from company directives.

Although voluminous work papers may not be necessary, there should be an adequate record of what has been done so as to support all findings in the internal auditor's reports and provide an adequate basis for the opinions expressed. Finally, all work papers should be reviewed by the chief internal auditor or, in larger organizations, by a regional or divisional auditor of senior rank.

REPORTING

The benefits of internal auditing are lost if the internal auditor's findings are not reported to management. The public accountant looks for reports that not only present clearly weaknesses in internal control and deviations from prescribed procedures but also indicate insofar as practical the persons or departments responsible for the deficiencies noted. In order to help ensure this type of reporting it is desirable that whenever a deficiency is noted it be accompanied by a comment as to whether (a) a prescribed procedure was violated (thereby fixing responsibility with departmental supervision), (b) the prescribed procedure was followed but does not provide satisfactory control (in which case the systems and procedures department is probably responsible), or (c) no prescribed procedure exists (in which event responsibility may vest in a staff department functionally responsible for the activity, the systems department, or both).

Public accountants are concerned with the promptness with which internal audit reports are rendered. If during the year the internal auditor notes deficiencies that may affect the financial statements, only prompt reporting will give reasonable assurance that corrective action will be taken before the year end.

FOLLOW-UP

Finally, the public accountant cannot be confident that internal audit is effective unless a good follow-up system exists. A copy of each audit report should be sent by the comptroller (assuming the internal auditor reports to the comptroller) to the head of the division audited, requesting him to state within a stipulated number of days, action which he has taken or proposes to take to implement the auditor's suggestions for correcting deficiencies reported or stating his reasons for disagreeing with the auditor's suggestions and offering his own proposals. In cases where disagreement exists between the operating departments and the audit staff, action to be taken would be decided by higher authority.

Comments in audit reports that require action by staff departments (industrial engineering, production control, purchasing, etc.) should be excerpted and sent to the staff department concerned with the same requirement for prompt action.

We would expect that particularly serious deficiencies would be called to the attention of top management by referring to it either copies of the reports noting the deficiencies or excerpts therefrom.

Follow-up correspondence should be filed with the related reports so that a clear record is available for future reference. In this connection, the internal audit schedule should be flexible enough to permit follow-up visits to those locations at which serious deficiencies have been noted in the past, so that the internal auditor may satisfy himself within a reasonable time on whether corrective action has been taken.

ACCOUNTS RECEIVABLE

There are two ways in which the public accountant relies on the work of the internal auditor. First, he may rely on work that the internal auditor does in conjunction with him. This may be referred to as coöperative auditing. A good example of this may be found in the confirmation of accounts receivable. Although the public accountant will select accounts to be confirmed, the internal auditor may prepare confirmation requests, investigate and resolve exceptions, and tabulate confirmation statistics under the control of the public accountant. To the extent that the internal auditor participates in this work the public accountant's work is reduced proportionately.

The second way in which the public accountant relies on the work of the internal auditor is by reducing his tests of the accounting records because he is satisfied as a result of the functioning of the system of internal audit that an adequate system of internal control is in effect. This type of reliance is the more significant. Turning again to accounts receivable for an example, if the public accountant is satisfied that the internal audit program provides for sufficient tests of the accounts receivable records to determine that the accounts are well controlled and that deficiencies are promptly reported and corrected, he may limit his own tests to a minimum. Although the public accountant must satisfy himself by personal observation concerning the nature of the accounting system and controls over receivables, he may be able to rely on internal audit to give him assurance that the system is consistently maintained.

With respect to the allowance for doubtful accounts, the public accountant must be satisfied through personal observation that the system established for estimating losses is adequate. However, if he is satisfied that there has been an adequate internal audit of the account, he should be able to limit his own review to a consideration of the reasonableness of the reserve in the light of the condition of the receivables as indicated by the aged trial balance and the internal auditor's observations. He should be able to rely considerably on the internal auditor's tests of credit department functions, including review of credit reports and the mechanics of arriving at the amount of the allowance required.

The public accountant may rely on internal audit in many ways in connection with inventory verification At least two opportunities for coöperative auditing come to mind. First, the public accountant and the internal auditor may agree to observe jointly the taking of the physical inventory. The public accountant would undoubtedly wish to observe the taking of the more significant segments of the inventory, but he may be willing to rely on the internal auditor's observations as to other segments. In a multiplant company, this may mean that certain locations are not visited by the public accountant at the inventory date because they are being visited by the internal auditor, or it may mean that the public accountant's observation at various locations is limited because internal auditors are participating with him in the observation of the inventories.

Another example of coöperative auditing with respect to inventories can be found in the checking of pricing and extensions. The public accountant can limit his tests in this area if he knows that in addition to his own tests the internal auditor has made substantial tests.

Even more important to the public accountant in his review of inventory accounts is the effectiveness of controls over inventories. And here again he looks to the internal auditor to ensure that prescribed procedures have been observed and that good control has been maintained. In order to be satisfied that the internal auditor has made the type of examination necessary to give this assurance, the public accountant will review the internal audit programs, work papers, reports, and follow-up correspondence. He will seek evidence of adequate tests in all phases of inventory control. Tests of standard cost calculations and variance reports, review of physical controls, production controls, and warehousing methods should all be provided for in the internal audit program.

Does the internal auditor investigate the reasons for differences between physical counts and perpetual records? Does he critically review changes in inventory turnover rates? The extent of the public accountant's reliance on the system of internal audit will be influenced very much by the answers to these questions.

One of the things that is often a problem to the public accountant is satisfying himself that all obsolete inventory has been written off or that an adequate reserve for obsolescence exists. In this area the internal auditor, because of his intimate knowledge of the company's affairs, is in an excellent position to judge whether all obsolescence has been reflected in the accounts. The public accountant will look for evidence that the internal auditor has reviewed over-age inventories for obsolescence and has made other appropriate tests to determine that the company's directives for reporting of obsolescence have been followed and that accounting action has been taken when required to reflect obsolescence. If he sees such evidence he may limit the work he does to supplement his own observations to a review of lists of obsolete stock reported by division or plant managements and the internal auditor's comments relating thereto.

OTHER AREAS IN WHICH THE PUBLIC ACCOUNTANT MAY RELY ON INTERNAL AUDIT

There is probably no phase of the public accountant's work that is not affected by a good system of internal audit. It is practical here to discuss only the more obvious areas in which the public accountant may rely on internal audit. In addition to receivables and inventories, several other areas fall in this classification.

CASH

If the internal auditor includes in his program a periodic verification of cash, the public accountant is justified in relying on this work and accordingly curtailing his own tests. This may mean that he verifies only large cash balances, relying on the internal auditor's work with respect to other cash accounts. Alternatively, he may review reconcilements checked by the internal auditor and restrict his own work to obtaining subsequent bank statements direct from the depositaries and performing his own cut-off check. Naturally, the public accountant will rely on reconcilements prepared or checked by the internal auditors only if they appear to have been prepared in accordance with acceptable auditing standards.

PREPAID EXPENSES

Many hours of audit time can be spent in verifying the computation of prepaid expenses. If the internal auditor has made appropriate tests to ascertain that prepaid expenses are being properly amortized, and his work papers contain supporting schedules for review, the public accountant should be able to limit his own work in this area to reviewing the accounts for unusual charges and rely on internal audit for tests of details.

ACCRUED LIABILITIES

Like prepaid expenses, accrued liabilities may require considerable time to verify in detail. Consider, for example, accrued taxes. A company doing business in many states will be subject to many different taxes. Determining that proper amounts have been accrued for franchise, property, sales, and payroll taxes can be a tedious job. However, if the internal auditor has made sufficient tests during the year to ascertain that accruals are properly adjusted periodically, the year-end verification by the public accountant may be reduced to a review of procedures followed and consideration of the reasonableness of the accruals in relation to the company's financial statements.

Accrued interest and accrued payrolls may be subject to the same approach in the presence of an effective internal audit system.

TRANSACTIONS

Tests of sales and other revenues, payrolls, purchases, and other transactions are included in an audit program for two reasons. First, the nature of the accounting system and internal controls must be determined so that the auditor may judge whether the financial statements produced as a result of the system are likely to be fair presentations. The public accountant has the responsibility for making this judgment and therefore must make tests sufficient for that purpose.

A second purpose of testing transactions is to determine whether the prescribed system has been consistently maintained during the period under examination. In the absence of effective internal auditing the public accountant will have to extend his tests sufficiently to satisfy himself in this respect also. However, if the internal auditor has made adequate tests of transactions on a regular basis throughout the year the public accountant should be able to limit his own tests of transactions to the extent necessary to understand the system, relying on internal audit for assurance that the system was consistently followed.

OPERATIONS AUDITING

Much attention has been given in recent years to *operations auditing,* which for the purpose of this discussion is to mean auditing that concerns itself with those functions of a business not necessarily reflected in the accounting records of the company. Consequently, it is auditing that depends on observation of the functions as they are performed rather than examination of the results of the operations as reflected in the records.

The public accountant has an interest in this type of internal auditing as well as in the conventional financial-type auditing. The reason for this is simple. The public accountant is concerned with the system of internal control. Although operations auditing seeks opportunities for greater efficiencies in conducting the company's operations, the internal auditor would be remiss if he did not consider the effectiveness of controls in conducting this phase of his work.

Engaging in operations auditing gives the internal auditor a greater opportunity to appraise controls over production, warehousing, capital expenditures, maintenance costs, and similar controls than he would otherwise have. Certainly it is important to the public accountant to have assurance that these controls are effective in conjunction with his need to know that the accounting controls are well maintained.

Examples

The following examples indicate weaknesses that may exist in a system of internal audit, and that would probably cause the public accountant to limit the extent of his reliance upon the system.

Company A

The internal audit department of Company A regularly visited all of the company's locations and rendered reports upon completion of each visit. Suggestions were made in these reports and correspondence with line departments indicated that a reasonable amount of effort was devoted to follow-up. However, examination of supporting work papers and programs showed that tests of transactions were almost entirely eliminated from the programs in an effort to spread a very small staff thin enough to cover all locations. The result was that although obvious failure regularly to comply with directives for preparation of bank reconcilements, receivable listings, and other monthly documents might be disclosed, there could be no assurance, based on the internal auditor's program, that daily transactions were consistently controlled and processed in accordance with management directives.

Company B

The public accountant, during his review of the internal control over cash disbursements of this company, noted that certain types of checks, after being signed by the authorized signer, were returned to the person who requested the issuance of the check for distribution to the payees. The management agreed this was a weakness and stated it would take steps to correct the situation. The internal audit department regularly tested cash disbursements and indicated this fact in their programs. It was therefore quite surprising to the public accountant when he learned six months later that an employee of the company had diverted cash to his personal use by requesting the check signer to return the checks to him so that he could forward them to the payees who, according to his story, were on the road and their day-by-day whereabouts was known only to him. When we questioned the company on how this situation could arise following the management's directive that this practice was to be stopped, we were told that in this particular case an exception had been made because of the convincing story given by the perpetrator of the fraud. On further review of the internal audit department procedures it was noted that although the internal audit department made adequate tests of cash disbursements it did not provide for an adequate follow-up of comments made in the past either by its own staff or by the public accountants.

Company C

This company is engaged in the processing of an agricultural product that must be bought during a rather short harvest season. The public accountant, in determining the tests to be made of the purchase records, selected representative transactions at various times of the year which naturally included a significant number during the harvest season in view of the fact that the bulk of the purchasing was done during that period. The results of his tests indicated that numerous errors existed, some of which had resulted in the company's paying more for their purchases than the contracts provided for. The internal auditor's reports applicable to the purchasing department of this company had noted consistent adherence to all prescribed procedures and good control. This of course conflicted sharply with the public accountant's findings but the reason soon became evident. The internal auditor, in planning his work, had invariably visited the purchasing department during the time of the year when they were extremely slack and selected for his tests transactions that occurred during this period because this was convenient not only for his own staff but particularly for the purchasing department personnel. Certainly this indicated very poor planning on the part of the internal auditor and practically eliminated any reliance that the public accountant should have been able to place on the work of the internal auditor in this area.

Company D

This company generated a substantial amount of readily saleable scrap during the course of its manufacturing operations. Because of the value of the scrap the company's head office negotiated on a company-wide basis for the sale of its scrap at the best possible price and instructed all its plants to sell the scrap to the nearest representative of the scrap dealer with which it had contracted. At one plant visited by the internal auditor he noted that the client's manager was selling scrap to a local scrap dealer rather than to the one designated by the head office. This fact was duly reported in the internal auditor's report and shortly thereafter appropriate steps were taken to see that the situation was corrected. However, the internal auditor overlooked one important fact.

The purpose of the head office directive was obviously not only to enable the company to be assured of a stable market for its scrap at the best obtainable price, but also to remove the control of this item from the local management. Because of the nature of the product it would have been a very easy thing for the local personnel to arrange for a kick-back from the local scrap dealer, yet this possibility was completely overlooked by the internal auditor and he failed to take the necessary steps to guard against this situation. If he had had more imagination he certainly would have checked the price obtained from the local scrap dealer with the price stipulated in the company contract. Furthermore, he would have checked the record of scrap sold with the production records in view of the fact that the nature of the company's operation was such that the amount of scrap produced as a result of its manufacturing operations could be rather accurately predicted. In this case the internal auditor was obviously effective in bringing to management's attention the deviation from the prescribed procedure but failed to appreciate the implications of his findings. Certainly the public accountant cannot put as much reliance upon the work of the internal auditor if he sees such a lack of imagination.

CONCLUSION

There is no better way of summarizing the thoughts expressed above than by relating a conversation between the chief executive of a company and his public accountant upon completion by the latter of a review of the system of internal audit. Internal auditing did not have enthusiastic support in this company and as a result the staff had decreased to a point where it was impossible to do the kind of a job that should have been done. However, despite this serious handicap the internal auditor was able to point out to management various weaknesses in the system of internal control, as a result of which corrective action was taken.

Although the management of this company failed to see in internal audit a constructive service to itself, it did feel that internal auditing resulted in reducing the time spent by the public accountant and therefore tolerated the practice. When the public accountant presented his recommendation that the internal audit department be expanded (at a significant increase in expense) in order to do a complete job, management acknowledged that it was seriously considering abandoning the internal audit department rather than expanding it, but wished to know what effect this course of action would have on the public accountant's fee. The public accountant said he would answer this question only if management would first answer a question for him: *To what extent would the system of internal control falter if there were no internal audit?*

In this case this question could not be answered by management because it had never been considered seriously, but if the management of any company will ask itself this question and make a serious attempt to answer it honestly it will have a good indication of the extent to which the public accountant can rely on the system of internal audit.