

University of Mississippi

eGrove

Proceedings of the University of Kansas
Symposium on Auditing Problems

Deloitte Collection

1-1-1992

Internal control: Progress and perils

Alan J. Winters

Dan M. Guy

Follow this and additional works at: https://egrove.olemiss.edu/dl_proceedings



Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

Auditing Symposium XI: Proceedings of the 1992 Deloitte & Touche/University of Kansas Symposium on Auditing Problems, pp. 177-191;

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Proceedings of the University of Kansas Symposium on Auditing Problems by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

8

Internal Control: Progress And Perils

Alan J. Winters

Dan M. Guy

American Institute of Certified Public Accountants

“Progress might have been alright once but it has gone on too long.”

Ogden Nash

Over the last five years, internal control has been a matter of widespread interest and vigorous debate, a subject where action is fast-paced and still gaining momentum. During the two preceding decades, however, internal control was an off-and-on again parochial topic, subject to the vagaries of groups who perceived it to be relevant and beneficial to their objectives. These groups included entity managers and owners, internal and external auditors, regulators and legislators, private sector policy makers, and independent commissions. In varying degrees, each of these groups has proffered internal control as a solution to a number of problems.

The intense attention devoted to internal control over the last five years (since 1986) has undoubtedly made progress in our understanding of what internal control is and how it can be used. Professional standards, private sector proposals, legislative and regulatory initiatives, and practice and academic research have addressed many conceptual and practical issues. However, not everyone would agree that all of these developments represent progress. Although some problems have been solved, some have not, and other problems have been created. In other words, internal control theory and applications have progressed, perhaps in an evolutionary leap since 1986, but perils remain.

The purpose of this paper is to survey the progress and perils related to internal control developments over the last five years. The content of both categories is likely to be disputed and the coverage will probably be incomplete. Even the co-authors of this paper are not in total agreement about what is progress and what is peril. Nevertheless, our objective is to review the most prominent advances and the most serious unresolved problems associated with internal control over the last half-decade. We leave it to our reviewer to propose our misclassifications and omissions.

Some of the developments discussed in this paper are neither new nor little known. They are presented for perspective and in an attempt to be thorough. Other developments we discuss, however, are emerging and not yet widely known. We believe that both areas contain pressing questions in need of research. As in many other areas of accounting research, research in internal control lags behind the needs of, or is overlooked by, policy makers and practitioners. This is likely a problem with the process used to identify and communicate policy and practice issues, stimulate research about them, and to foster an

awareness of existing research — that is, our internal control over useful and relevant research may contain a material weakness or, at least, a reportable condition. We hope that our paper gives better focus to research needs in internal control.

This paper is organized into three major sections each framed as a question: (1) What is internal control? (2) What is the relationship of internal control to an effective audit strategy? and (3) What is the value of information about internal control? To some extent these categories overlap and other organizational frameworks certainly exist, but we believe these categories aptly identify the major areas where key developments have occurred during the last five years.

What Is Internal Control?

Prior to 1987, there were many efforts to define and describe internal control. A number of these efforts were rooted in the need to postulate and understand the relationship of internal control to financial reporting and auditing, commonly referred to as “internal accounting control.” Several notable examples of these efforts are *Statements on Auditing Procedure No. 54, The Auditor’s Study and Evaluation of Internal Control* [AICPA, 1972], *The Report of the AICPA’s Special Advisory Committee on Internal Control* [AICPA, 1979], and *Internal Control in U.S. Corporations: The State of the Art* [Mautz, et.al. 1978].

Other treatises on internal control took a broader perspective, probing internal control as it relates to the organization as a whole. Some prominent examples of these works are: *Management Control Systems* [Anthony and Dearden, 1972], *Control in Business Organizations* [Merchant, 1985], and *Statement on Internal Auditing Standards No. 1, Control: Concepts and Responsibilities*, [IIA, 1983].

In 1987, two separate and extensive endeavors to redefine and redescribe internal control began. Each of these undertakings broadened and refined the concept of what internal control is and, in somewhat different ways, addressed the need for an authoritative or “generally accepted” definition of internal control. We refer to those endeavors as SAS 55 [AICPA, 1988] and the Treadway/COSO [COSO, 1992] reports.

SAS No. 55

In February 1987, an exposure draft of a proposed statement on auditing standards (later to become SAS 55) was released. Although the proposal dealt principally with the relationship of internal control to an audit of financial statements, it also broadened the AIPCA’s authoritative definition of internal control beyond that in SAP 54 and elaborated on its elements.

Statement on Auditing Standards No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, (SAS 55) was issued in April 1988. It introduced the term internal control structure and defined it as consisting of an entity’s “policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved.” The standard subdivided the internal control structure into three major elements: the control environment, the accounting system, and control procedures. An appendix to SAS 55 and a subsequent audit guide elaborate on these three elements in considerable detail.

We believe that SAS 55 improved the definition and description of internal control, as it relates to financial statement audits, in three principal ways. First,

it expanded the elements that comprise internal control over financial statements and that auditors, therefore, should consider when assessing control risk. Second, it linked consideration of internal control to financial statement assertions, requiring auditors to focus their consideration of internal control on its effect on the specific assertions being audited. Both of these definitional improvements should bring progress in the form of better control risk assessments. Third, the revised definition specifically embraced internal control over data used to apply audit procedures, for example internal control over nonfinancial data used in analytical procedures. This definitional change brought the “operational” aspect of internal control squarely within the purview of a financial statement audit. By removing the clouded and unworkable distinction between accounting and administrative control in SAP 54, the new definition should improve both audit effectiveness and efficiency through the use of operational information.

These areas of progress, however, are not without perils. One of the elements included in the expanded definition of internal control, the control environment, contains several components that auditors may find difficult to evaluate and relate to financial statement assertions. For example, judgments about what constitutes an appropriate management philosophy and operating style or an effective organizational structure or audit committee and how those components affect specific financial statement assertions are somewhat subjective and somewhat new to auditors. In addition, what constitutes effective internal control over operational information and, in turn, how such information relates to financial statement assertions is largely unexplored and, we expect, not yet widely used in auditing.

Research needs concerning the progress and perils of SAS 55’s definition of internal control include the following questions:

- To what extent are auditors considering the control environment components in assessing control risk (as opposed to assuming control risk is maximum)?
- How do auditors evaluate the effectiveness of control environment components and what specific problems are they encountering?
- How do auditors combine or integrate the control environment with the other two internal control structure elements in assessing control risk?
- How do auditors link the control environment (as a whole or by components) to financial statement assertions?
- Have auditors’ assessments of control risk improved by considering the control environment components?
- How and to what extent is nonfinancial data used in an audit and how are controls over such data identified and evaluated?

Treadway/COSO Reports

In October 1987, the National Commission on Fraudulent Financial Reporting (Treadway Commission) issued its report. Included among its numerous recommendations for reducing the incidence of fraudulent financial reporting were several recommendations concerning internal control. One of these recommendations was specifically addressed to the question of what is internal control and suggested that the committee of organizations sponsoring the Treadway Commission (COSO) develop integrated guidance on internal con-

trol. The report's discussion of the recommendation stated that varying interpretations and philosophies of internal control existed and that a common reference point about what effective internal control is was needed.

In response to this recommendation, COSO, through an outside consultant, (Coopers & Lybrand) embarked on a project to develop integrated, generally accepted internal control guidance. An exposure draft of this guidance was issued in March 1991. After considering comments, a revised exposure draft was issued in February 1992, and the final report is expected to be issued in September 1992.

The stated objectives of the report are to establish a common definition of internal control which serves the needs of different parties (general acceptance) and to provide a standard against which the internal control effectiveness can be evaluated (criteria). These are admirable but ambitious goals. Their achievement would represent substantial progress. Agreement about what internal control is and how effective internal control can be achieved would be a major step toward helping entities establish sound internal control and providing useful information about internal control. Indeed, initial indications suggest that these goals may be attainable. For example, regulatory agencies charged with implementing the FDIC Improvement Act of 1991 have indicated they will adopt the COSO report as the standard against which both the required management and auditor assessments of internal control effectiveness required by the act should be judged. The growth in other legislative and regulatory interest in internal control may provide additional impetus for imbuing the COSO report with "general acceptance" (in the AICPA's auditing standards division, for example, we have been involved with over a dozen regulatory agency proposals for auditor reports on internal control within the last four months).

More experience implementing the COSO report is needed, however, before its success can be evaluated. There are a number of critics of the report who see more peril than progress in its content. The major perils posed by the report can be classified into two areas: (1) the definition of internal control and the related components (criteria) the report establishes for effective internal control, and (2) the measure of significant deficiencies the report sets forth.

COSO defines internal control broadly as "a process, effected by an entity's board of directors, management and other personnel, which is designed to provide reasonable assurance regarding the achievement of objectives in one or more categories: effectiveness and efficiency of operations, reliability of financial information, and compliance with applicable laws and regulations." The report also identifies five components of effective internal control: (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring. These components represent criteria or standards for establishing and evaluating effective internal control.

It seems intuitively reasonable to establish internal control categories that correspond to the three major categories of entity objectives (financial reporting, compliance, and operations). This categorization permits universal criteria to be applied to major segments of internal control. As the COSO report states, these categories allow a directed focus on internal control by different parties to suit their specific needs. Such a categorization, however, also creates a perception that internal control components within these categories are clearly identifiable and distinguishable and that experience and expertise in applying the COSO criteria is equally well-developed for each of these categories.

This perception is not valid and, although the COSO report attempts to dispel the inference, our experience with numerous regulatory requests for auditor services on internal control demonstrates that the misperception is common. For example, the Chief Financial Officers Act of 1990 requires an auditor's opinion on internal control over financial reporting, compliance with laws and regulations, and certain operations objectives. In addition, the act requires auditors to "review management's process for evaluating and reporting on internal control."

While we have a fairly well-developed body of knowledge about how to apply the COSO criteria to internal control over financial reporting, our knowledge of how to implement these criteria for internal control over compliance and operations is extremely limited. For example, how do we implement the risk assessment, control activities, and information and communication criteria for the categories of compliance with laws and regulations or operations?

Regulatory initiatives calling for such implementation are fast outpacing our ability to provide those services. We have found in our experience at the AICPA that regulators often have unachievable expectations about the services independent auditors can provide regarding internal control in the compliance and operations categories. For example, we have had requests for auditors to provide opinions that an entity has adequate internal control to ensure compliance with laws and regulations requiring drug free workplaces and nondiscrimination in providing housing. Consequently, when legislative and regulatory bodies request services concerning internal control, we are careful to always use a modifier with the term internal control—financial reporting, compliance, or operations—to help avoid misunderstanding.

Another concern about the COSO criteria is that certain components may be so subjective as to not be susceptible to reasonably consistent estimation or measurement. Those components most often cited include integrity, ethical values, and management competence. Management (or auditors) may not be able to determine objectively whether those criteria have been satisfied, yet their existence as criteria is likely to create the expectation that they have. On the other hand, however, the COSO criteria may currently be at the same evolutionary stage that generally accepted accounting principles were at forty years ago. Refinement is probably necessary and likely to occur.

Another peril arises because the report uses the concept of a material weakness to separate effective from ineffective internal control. Using this measure causes two problems. First, no conceptual or empirical construct of a material weakness exists for internal control over either compliance or operations. The construct has been developed only for internal control over financial reporting by relating deficiencies in internal control to the likelihood of material misstatements in the financial statements. Obviously, such a construct is not an appropriate measure of a material weakness in either internal control over compliance or operations. In the absence of sound definitions of material weaknesses pertaining specifically to both the compliance and operations categories, the decisions of those who evaluate internal control in those categories and those who use such evaluations will be subject to extreme variations in consistency and usefulness.

Even though an accepted material weakness concept exists for internal control over financial reporting, it also poses complications. There are strong disincentives to concluding that such weaknesses exist. Practice experience in both

financial statement audits and in engagements to report on internal control under SAS 30 indicates that material weaknesses rarely exist. This rarity stems from the perception that their existence constitutes a violation of the Foreign Corrupt Practices Act of 1977. As a result, deficiencies in internal control are almost never deemed sufficiently significant to be material weaknesses and useful information about internal control is suppressed. Indeed, SAS 60 was developed to foster the flow of useful information about internal control over financial reporting by creating an additional, lower-level deficiency not embedded in legislation—a “reportable condition.” Because of the legal implications of material weaknesses, COSO’s decision to adopt that concept is likely to perpetuate their rarity.

An additional concern with the material weakness construct (for each of the three control categories) is that it may not be operational for some of the criteria—particularly the control environment criteria. What constitutes a material weakness in integrity, ethical values, management competence, or management philosophy and operating style? Applying the material weakness concept to these criteria is likely to create a very fuzzy line between effective and ineffective internal control, with the result that the identification of such weaknesses will be rare. Moreover, the lack of material weaknesses may lead to unwarranted implications, for example, that management is effective.

Research needs concerning the progress and perils of the internal control definition and criteria in the COSO report include the following areas:

- The extent to which the COSO report definition and criteria has been adopted, voluntarily or mandatorily, by entities that report on internal control.
- The implementation of the five COSO criteria in each of the three internal control categories, with special considerations to the compliance and operations categories—problems encountered and refinements needed.
- The decision processes management and auditors use in deciding whether material weaknesses exist in each of the three categories.
- The application of COSO criteria to smaller entities and specific industries.
- The relationship between the SAS 55 definition of internal control and the COSO definition and the need for reconciling SAS 55 to COSO.

What Is the Relationship of Internal Control to an Effective Audit Strategy?

The proposal and ultimate issuance of SAS 55 sparked considerable controversy about the validity of some of its concepts and whether its implementation would have a positive or negative effect on financial statement audits. Because SAS 55 is the authoritative guidance for forming judgments about internal control effectiveness and incorporating them into a financial statement audit, concerns about its conceptual validity and implementation are critical. Moreover, portions of SAS 55 are being adapted as guidance in attestation standards the Auditing Standards Board (ASB) is developing for auditors to use in performing and reporting on internal control effectiveness using the COSO report. Thus, issues concerning SAS 55 have taken on added significance.

Some of the potential progress and perils associated with SAS 55 were discussed in the previous section. This section will consider other significant areas

of advances and hazards directly attributable to SAS 55. The areas of controversy we believe to be of the greatest consequence are: (1) the meaning of control risk and (2) the nature and application of tests of controls.

What Is Control Risk?

The concept of control risk was first recognized in auditing standards with the issuance of SAS 39. Control risk was further refined and given more prominence by SAS 47; SAS 55 sets forth the most recent amplification of that concept. Some commentators, however, believe that SAS 55 changed the concept of control risk significantly from that in prior standards and made it theoretically and operationally unsound [Morton and Felix, 1990, 1991].

SAS 55 defines control risk as “the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity’s internal control structure policies and procedures.” This definition is essentially the one in SAS 47 modified to accommodate the SAS 55 requirement that control risk be assessed at the assertion level. The fundamental disagreement over this definition is whether it means that the assessed level of control risk must always represent the auditor’s belief (estimate) about the true but unknown level of control risk or whether, for audit efficiency reasons, an auditor may decide not to confirm that belief and arbitrarily set control at the highest possible level (100%).

The essence of this disagreement was stated clearly and concisely by Morton and Felix [1990] “...[I]t seems unreasonable to assume that an auditor either has no beliefs until competent evidential matter is collected, or that his beliefs are irrelevant unless sufficient evidential matter is collected to provide a basis for reliance thereon.” Some believe that such an assumption, instead of being unreasonable, is prudent. Stated differently, what support should exist for a belief that the level of control risk is below 100% before that belief can be used in the audit? Should auditors be permitted¹ to use beliefs for which they have not gathered evidence or should they be required to obtain evidence to support those beliefs before they are used in the audit process?

Research about internal control judgments has been abundant and fruitful. Additional consideration is needed, however, of how audit effectiveness differs when auditors use beliefs about control risk that are unsupported by tests of controls as opposed to when auditors assume control risk is 100%. Some important questions are:

- When an auditor has a tentative but unconfirmed belief that control risk is less than 100% but believes it is inefficient to perform tests of controls to confirm the belief, what is the role of those unconfirmed beliefs in the audit process (normative and descriptive)?
- When an auditor has a tentative but unconfirmed belief that control risk is less than 100% but believes it is inefficient to perform tests of controls to confirm the belief, what is the affect on the audit process of setting control risk at 100%?

¹ Morton & Felix [1991, pp. 4-5] strongly imply that use of an unsubstantiated belief that control risk is less than 100% should not only be permitted but required. The rationale is that the audit will be more effective than if the auditor assumes control risk is 100% and audits accordingly.

The meaning of control risk raises other questions apart from financial statement audits. Because the risk model is incorporated in the attestation standards, control risk applies to assertions other than financial statements. Therefore, in addition to questions about the meaning of control risk in financial statement audits, audit policy makers are being confronted with questions about the meaning of control risk in the context of an audit of an entity's compliance with laws and regulations and its operations results. Even more modernistic and intriguing are questions about the meaning of control risk in an audit of internal control—that is, what does control risk mean and how should it be considered when an auditor is engaged to express an opinion on the effectiveness of internal control over financial reporting, compliance, or operations?

What Are Tests of Controls?

Tests of controls are audit procedures performed to evaluate the effectiveness of the design or operation of internal control structure policies or procedures. They consist of four major categories:

- (1) Inquiry of appropriate entity personnel.
- (2) Inspection of documents and reports.
- (3) Observation of the application of policies or
- (4) Reperformance of the application of policies or procedures by the auditor.

This definition and description of tests of controls, summarized from SAS 55, is probably the most controversial aspect of the standard.

Some commentators on SAS 55 believe that its construct of tests of controls has reduced the extent and relaxed the nature of control testing [for example, Kinney and Felix, 1992] Other commentators believe that the construct has achieved exactly the opposite effect—control testing is more prevalent and more focused than it was prior to SAS 55 [see, for example, Sullivan, 1988].

Commentators in the first group believe that “tests of controls” has had a deleterious effect on audit effectiveness that manifests itself in (1) a de-emphasis of testing controls at the transaction level, (2) a de-emphasis of reperformance tests, and (3) a decline in the use of sampling in testing controls. They believe that these conditions are symptomatic of underauditing; that inquiry, observation, and document inspection are inherently less rigorous and reliable than reperformance; and that sampling is significant, if not essential, to proper evaluation of control effectiveness.

Remarkably, commentators who support the test of controls concept in SAS 55 agree that the three conditions enumerated above have occurred, but believe that they reflect a shift to a more effective audit approach brought about by SAS 55. In other words, SAS 55 was intended to create the above three conditions as a means of improving audit effectiveness.

Indeed, the explanation for different interpretations of the same set of events lies in the perception of what constitutes audit effectiveness. Most proponents of SAS 55 believe that previous internal control standards failed to concentrate the auditor's internal control consideration on the primary sources of misleading financial statements: improper or biased selection and application of accounting principles, biased judgments about accounting estimates, and inaccurate or incomplete disclosures. Instead, in their view, the old standards focused the auditor's internal control efforts primarily on financial statement misstatements

resulting from clerical or processing mistakes.

This perception of what the focus of internal control work should be underlies the broadening of the definition of the internal control structure in SAS 55. The expansion was intended to direct the auditor's control work toward control components considered to be most relevant to the major sources of financial statement misstatements. As a result, the expanded definition brought the control environment and the accounting system directly into the scope of the auditor's consideration. SAS 55 accommodated these two new control components by recognizing tests suitable to their nature. These tests were labeled tests of controls and included the types of procedures set forth in the initial paragraph of this section.

The design and operation of most of the control environment components and many of the accounting system components cannot be tested at the transaction level, or by reperformance, or through the use of sampling. Yet these components are much more closely associated with the primary causes of financial statement misstatements than are controls over individual transactions. Furthermore, because of the increased use of EDP applications, the most effective approach to considering the control procedures component is often to focus on the higher-level, supervisory control procedures (general controls). These control procedures also cannot be tested at the transaction level, or by reperformance, or through the use of sampling.

Whether SAS 55 has created a proper focus on internal control, whether auditors have understood and implemented that focus in their audit approaches, and whether the tests of controls established by the standard provide reliable evidence and are being implemented properly will no doubt continue to be debated. These questions pose important research opportunities for assessing the progress and perils of SAS 55.

What Is the Value of Information About Internal Control?

Effective internal control is valuable because it helps achieve objectives. In addition, however, there is a growing belief that information (reports) about the effectiveness of internal control is also valuable. The value of such reports is virtually indisputable for some uses. For example, reports about internal control effectiveness are indispensable to management in achieving sound control. In fact, one of the five COSO criteria, monitoring, explicitly recognizes the need for such information. Reports about internal control for other than management's use, however, is viewed as progress by some and peril by others. It is the value of these other uses we discuss in this section. Throughout the remainder of the paper, we use the term "reports" to mean an independent auditor's report on an entity's internal control. Although such reports may not be accompanied by a separate management assertion on internal control effectiveness, we consider such an assertion to be at least implicit.

Calls for reports on internal control are not new. Various bodies have proposed or supported both voluntary and mandatory reports. These groups include independent private-sector commissions (Cohen & Treadway Commissions), legislators & regulators (Wyden & Dingell and SEC), and professional groups (AICPA and FEI). Although it is not our purpose to recount this history, a good summary of it can be found in Appendix A of the COSO report.

More activity in the area of reports on internal control effectiveness has occurred during the last five years than at anytime in the past. Although some

recommendations have come from the private sector (notably the Treadway Commission) and some reports have been issued voluntarily by public companies, by far the most activity has been in government. The following list provides some examples of internal control reports that the government has mandated within the last five years and that involve independent auditors.

- FDIC Improvement Act of 1991
- CFO Act of 1990
- OMB Circular A-133
- Government Auditing Standards (Yellow Book)
- HUD Program Audit Guide
- Student Financial Assistance Programs Guide
- Mortgage Banker Single Audit Program
- REA Borrower Audits Program
- Aviation Safety & Capacity Expansion Act of 1990

In addition to these recent initiatives, other requirements for reporting on internal control have existed for some time, for example reports involving casinos, investment companies, depository trust companies, securities transfer agents, and a myriad of entities subject to OMB Circular A-128—each of these situations also include some type of independent auditor involvement.

The content of current internal control reports varies in at least eight major areas:

- (1) Category of internal control reported on (financial reporting, compliance, or operations).
- (2) Aspect of internal control reported on (design, placed in operation, or operating effectiveness).
- (3) Presence or absence of separate management assertion (report) about internal control.
- (4) Criteria used to judge internal control quality (SAS 30, SAS 55, COSO, agreed-upon criteria).
- (5) Measure of deficiencies to be reported (material weakness, reportable condition, material inadequacy).
- (6) Auditor service (examination, agreed-upon procedures, by-product of other services).
- (7) Assurance provided (opinion, negative assurance, negative/positive assurance, findings only).
- (8) Report distribution (public, restricted).

This brief overview of current reporting on internal control demonstrates a strong demand for such reports and the serpentine reporting practices associated with them. Whether the demand reflects an intrinsic utility in such reports is arguable. (After all, the demand is largely regulator induced and not subject to free market considerations of cost and benefit.) Whether the cobweb of report contents enhances or diminishes the meaningfulness of such reports is also an open question.

Report Demand

The fundamental proposition underlying a demand for reports on the quality of internal control is that reporting on the *output* of a *process* is not enough. Reporting on the process itself is also necessary. Stated somewhat differently, if

a report about the output of a process is available, does a report about the process that produced that output add incremental value?—is one type of report simply a substitute for the other? Exhibit 1 illustrates this concept using the three categories of objectives presented in the COSO Report.²

Exhibit 1
Relationship Between Internal Control Structures and Products

Internal Control Structure

Financial Reporting
 Compliance with Laws & Regulations
 Operations Requirements

Product

Financial Statements
 Compliance Performance
 Operations Performance

Currently, independent auditors provide assurance about each of the three outputs in Exhibit 1. They audit financial statements, express opinions on whether the requirements of laws or regulations have been complied with, and provide assurance about whether the outcome of operations meets certain specifications.³ As noted earlier, however, auditors also currently provide assurance about internal controls over financial reporting, compliance with laws and regulations, and operations. If this latter type of service satisfies an unmet need in a cost-beneficial manner without creating unwarranted expectations, then such services represent progress. If not, perils exist. There are arguments for both positions.

Those who advocate reports on internal control usually cite two major benefits. One benefit pertains to the act of reporting itself (a behavioral effect) rather than to the information content of such reports. The premise is that reports on an entity’s internal control will cause its management to devote more attention to internal control quality and, therefore, better internal control will result. Improved internal control, in turn, will yield improved output, e.g., more reliable financial reporting, greater compliance with laws and regulations, and better operating performance.

This perceived benefit may pertain more to compliance and operations objectives than to financial reporting objectives. If internal control (process) does not achieve financial reporting objectives, then an audit of the current-period financial statements (output) can be used to achieve those objectives—change the financial statements based on the audit. Thus, even if the act of reporting on internal control over financial reporting (process) does improve that internal control, it does not add anything to the achievement of financial reporting objectives beyond what an audit of the financial statements (output) can achieve.

The same is not true for the compliance and operations categories of internal control. If internal control (process) does not achieve current-period compliance

² Although this relationship is seemingly straightforward, our experience has been that internal control over a specific process is often confused with the output that process produces.

³ As an example of an engagement involving operations specifications, the Environmental Protection Agency has requested that auditors provide assurance on the oxygenate content of gasoline distributed in various areas of the United States.

and operations objectives, an audit of the current-period compliance and operations performance (output) cannot be used to change the current-period results to achieve those objectives. Consequently, if the act of reporting on internal control causes management to devote more attention to internal control and thereby improve it, then reports on internal control over compliance and operations may add to the achievement of current-period objectives in each of those areas beyond what an audit of the output provides.

The other major benefit of reports on the quality of internal control relates to their information content. The premise is that such reports provide information that is not available from reports on the output of the process. That is, reports on internal control provide information relevant to decisions about an entity that cannot be satisfied by reports on the output.

In the area of internal control over financial reporting, the argument has been made that reports about the quality of internal control serve to provide needed information about an entity that is not available from its financial statements [Hooten and Landsittel, 1991]. For example, two entities might have the same financial position and operating results for a given period yet one entity have sound internal control and the other inadequate internal control. Financial statements do not provide information about the quality of internal control. Yet, the argument goes, the quality of internal control is a critical indicator of the entity's future success. Those who make decisions about an entity need information about internal control to be effective decision makers.

Opponents of this argument point out that its validity depends heavily on what categories of internal control are reported on. Poor internal control over financial reporting can be compensated for by auditing the financial statements—annual, interim, or both. Thus, for the financial reporting category, the argument boils down to which type of information is least costly to provide. Providing information about internal control over financial reporting does not seem to supply any incremental value beyond that afforded by audited financial statements—no progress, just peril.

If, however, the compliance and operations categories of internal control are reported on, additional information value may arise. The rationale relates to the inherent difference, discussed earlier, between the category of financial reporting objectives and the categories of compliance and operations objectives. Current-period compliance and operations performance cannot be changed to meet objectives based on an audit of actual results, as can financial reporting performance. Thus, reports on the quality of internal control over compliance and operations may indeed provide “early warning” information about whether objectives in either of those areas will be achieved. That is, reports on internal control quality in each of these areas may provide information about risks and uncertainties attendant to achieving the related objectives that audits of the actual results cannot provide as quickly or cannot provide at all. Stated differently, although an audit of the compliance or operations output may reveal that objectives were not achieved, it may be too late to do anything about it. On the other hand, reports on internal control over both areas may provide time to make adjustments to accomplish these objectives.

Not everyone agrees, however, that reports on internal control over compliance and operations provides incremental information in the most cost-effective manner. Opponents to such reports often argue that the type of output provided is the key consideration. If historical results do not provide timely information,

other types of output do. For example, improved reporting of specific risks and uncertainties or required financial forecasts, both attested to by independent auditors, have been suggested as better alternatives to reports on internal control.

In our view, not much progress has been made in resolving the questions concerning the relative merits of reports on internal control versus reports on output. Although the demand for reports on internal control is growing, much of it stems from legislative and regulatory requirements. This source of demand raises the question of whether reports about the quality of internal control are of more value to specific users than to the general public.

Report Users

Currently, reports on internal control are issued to both specific parties, such as regulatory agencies, and to the general public. Unlike the general public, however, a specific party's relationship with an entity may be directly affected by the entity's internal control. For example, a specific party may provide funding to an entity under the condition that certain internal control requirements be met to help ensure that the funds are used appropriately. Because of such relationships, specific parties usually have a clearer understanding of the purpose and limitations of internal control, internal control reports and the auditor's services are generally tailored to their specific needs, and they are able to require the entity to take certain actions if internal control is deficient. We believe, therefore, that internal control reports are much more useful for these parties than for the general public, and less likely to create perils for management and their auditors.

Reports to the general public are much more hazardous than those to specific users; hazardous to the public, the entity, and its auditors. The public, in general, does not have as clear an understanding of the purpose and limitations of internal control as specific parties do. In addition, the general public cannot take specific actions to compel an entity to alter its internal control on the basis of an internal control report. At most, members of the investing public might alter their investment decisions about an entity based on the reported quality of its internal control. Investors' ability to factor information about internal control into their investment decisions, as alluded to earlier, is contentious and largely unexamined. Public reports on internal control should be discouraged until there is a better understanding of the relationship between information about an entity's internal control and its potential for success.

Report Content

As noted previously, the content of internal control reports varies considerably. Much of the variation is attributable to the piecemeal fashion in which reporting on internal control has developed. Professional standards, instead of providing a general framework for reporting on internal control, have permitted considerable flexibility in such reporting. These standards have, for the most part, addressed individual internal control engagements as the need arose, creating a wide diversity of performance and reporting requirements. The myriad forms of internal control reports has created confusion not only among report users, but also among the practitioners who are asked to provide them.

Only recently has the ASB acted to promulgate a general framework for reporting on internal control. Currently, the ASB has an exposure draft of an

attestation standard for reporting on internal control over financial reporting outstanding and is developing another for reporting on internal control over compliance with laws and regulations. These standards should help achieve greater consistency in both the performance standards for internal control engagements and the resulting reports.

There is concern, however, that, through the combination of the COSO report criteria and the proposed attestation standard on internal control over financial reporting, too much homogeneity in reports will result. If the concept of material weaknesses, as prescribed in both the COSO report and the proposed attestation standard, results in the virtual absence of material weaknesses (for reasons discussed earlier), all reports will look alike. These boilerplate reports are not likely to have much information content and, instead, serve only as a basis for litigation against management and auditors if the entity encounters problems in the future.

Research needs concerning the progress and perils of the value of reports on internal control include the following questions:

- Does the act of reporting on internal control cause management to improve internal control quality?
- Can reports on internal control over financial reporting, compliance, or operations provide information beyond that available from reports on the output?
- How do regulators (or other classes of specific parties) determine their information needs about internal control and use the information in internal control reports?
- How does the general public perceive and use internal control reports?
- What is the content of internal control reports issued to the general public and in what significant ways do these reports differ?

Summary

The brisk activity in internal control over the last five years has raised new issues about internal control and renewed emphasis on old issues. Many of the developments flowing from this activity have gone beyond the discussion stage and into implementation. In several instances, implementation has been undertaken on the faith or perception that the actions will be beneficial and, thus, have bestowed an urgency on the need to understand their effects.

Because implementation is taking place, data now exists, and we hope is accessible, for empirical research on many theoretical internal control issues. We hope that efforts will be devoted to this research and that this paper will help to focus them.

References

- American Institute of Certified Public Accountants (AICPA), *Statement on Auditing Procedure No. 54: The Auditor's Study and Evaluation of Internal Control* (New York, 1972).
- American Institute of Certified Public Accountants (AICPA), *Statement on Auditing Standards No. 30: Reporting on Internal Accounting Control* (New York, 1980).
- American Institute of Certified Public Accountants (AICPA), *Statement on Auditing Standards No. 55: Consideration of the Internal Control Structure in a Financial Statement Audit* (New York, 1988).
- American Institute of Certified Public Accountants (AICPA), *Statements on Auditing Standards No. 60: Communication of Internal Control Structure Matters Noted in an Audit* (New York, 1988).

- Anthony, R.N. and J. Dearden, *Management Control Systems* Richard D. Irwin (1972).
- COSO, "Internal Control-Integrated Framework," (Committee of Sponsoring Organizations of the Treadway Commission, Revised Draft February 1992, further revised based on recommendations of the April 13, 1992 COSO Advisory Committee meeting.)
- Hooten, J.G. and D.L. Landsittel, "Addressing 'Early Warning' and the Public Interest: Auditor Involvement with Internal Control," *CPA Journal* (June 1991), pp. 10-13.
- Institute of Internal Auditors, *Statements on Internal Auditing Standards No. 1: Control: Concepts and Responsibilities*, (Altamonte Springs, 1983).
- Kinney, W.R., Jr. and W.L. Felix, Jr., "Implementing SAS No. 55: An Interim Report," Expectation Gap Roundtable (AICPA, 1992).
- Mautz, R.K., W. G. Kell, M.W. Maher, A.G. Merten, R.R. Riley, D.G. Severance and B.J. White, *Internal Control in U.S. Corporations: The State of the Art*, Financial Executives Research Foundation, New York (1980).
- Merchant, K. A., *Control in Business Organizations* (Pitman, 1985).
- Morton, J. E. and W.L. Felix, Jr., "Assessing Control Risk: Effects of Procedural Differences on Auditor Consensus," *Proceedings of the 1990 Deloitte & Touche/University of Kansas Symposium on Auditing Problems* (1990), pp. 109-131.
- Morton, J.E. and W.L. Felix, Jr., "A Critique of Statement on Auditing Standards No. 55," *Accounting Horizons* (March 1991), pp. 1-10.
- Sullivan, J.D., "Why the Auditing Standards on Evaluating Internal Control Needed to be Replaced," *Proceedings of the 1988 Deloitte & Touche/University of Kansas Symposium on Auditing Problems* (1988), pp. 47-54.