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Discussant's Response to An Auditing Perspective of the Historical Development of Internal Control

Rodney J. Anderson

Clarkson, Gordon & Co.

By way of explanation relative to my remarks as discussant, please consider that it was only yesterday that this paper reached my hands.

The paper may be said to consist of three elements:

1. An overview of the historical development of auditing and internal control,
2. The development of North American thinking on internal control during the 20th century, and
3. Present thinking on internal control and internal auditing.

I will organize my comments with respect to each of these three elements and finally use the third as a jumping off point for a few other related thoughts about control.

Overview of Historical Development

The first eight pages, indeed half the paper, deal with an overview of the historical development of auditing and control. I found this interesting and readable. I think it gives a good summary of the early beginnings. Perhaps it could have gone a little more into the big jump from Charlemagne to the Industrial Revolution—a period where, I think, the roots of many of our present practices may be found. I will refer again to this presently. The authors state that control was the natural product of the profit motive. In the general sense of human acquisitiveness (“Let’s protect what we’ve got.”—and what we’re getting), I agree. But in the narrower sense, profit motive suggests commercial transactions. In contrast, it was more commonly the wealth and the taxing power of the ruler or government which was being protected in those precursory days. As an oversimplification, we might say that control in auditing began with public funds (if one may use that euphemism for the ruler’s hoard). And perhaps if the government take of the GNP continues at its present rate, we will soon come full circle. And future historians may look wistfully back at the 19th and 20th centuries as the age of private enterprise. However, that’s not the subject for this conference.

In any case, whether the very beginnings were private-commercial or ruler-public is always a little difficult to tell from the literature. Certainly the examples of Egypt, Persia and Rome are all public funds examples. On the other hand, it

may simply be that such archeological records survive more easily. The references to Sumerian transactions in 3600 B.C. may indeed be commercial. Similarly, I located an interesting excerpt from one of the provisions of Hammurabi's code from Babylon of 2200 B.C. Article 105 reads: "If an agent has forgotten and has not taken a sealed memorandum of the money he has given to the merchant, money that is not sealed for, he shall not put in his accounts." This would certainly seem to be commercial and would suggest the keeping of commercial accounts and rudimentary elements of internal control.

And yet, one can find conflicting quotations. Dr. Budge of the British Museum was quoted as saying in 1905: "There is no reason for thinking that they (the Babylonians and the Syrians) managed their money affairs as we do. There are many contract tablets known, and hundreds of records of commercial transactions, but I know of none which could be considered as accounts in the modern sense of the word."

Be commerce as it may, the control and audit of government funds was surely the predominant influence on early developments.

Mention is made of the division of duties among the Pharaoh's scribes—and certainly division of duties is still an important element of internal control. Likewise, mention is made of the Persian surprise audits. Similarly, one might add, the Greeks had a group of checking-clerks to check public officials' accounts.

The paper goes on to refer to the quaestors and the division of duties over the Roman funds—and the source of the word audit as a hearing. Indeed, the division of duties there saw legislative control over public revenues and expenses vested in the Senate, the power to order payments vested in the censors, the farming of tax collection rights to publicans by the censors in the presence of the quaestors, and the actual handling of receipts and payments by the quaestors. Certainly this was an elaborate system of control.

The account then touches on the Holy Roman Empire and Charlemagne—and again this involves control and audit of government funds.

Then comes the gap—a jump to 1850 and the Industrial Revolution. But it is during this gap that we see the main switch from control and audit of government alone, to control and audit of commerce—at least more as we know it today.

The authors merely refer to the period of 1500 to 1850 as a birth of double entry. I think this might have been explored further since double entry has surely become one of the most important, though rudimentary, elements of internal control. The first evidence of double entry seems to be in Genoa in 1340 and involved the stewards to the local authority (again government). From there it moved to Venice and became known as "method of Venice." Later it moved to Florence. Why this growth? Of course, it was due to the Italian maritime expansion. We all remember that it was during this period that the Italian merchant fleets spread all over the world—indeed, providing the source of the name "America." Ships coming from the East and from the New World were financed principally as joint ventures, and pre-eminent among these were the Venetian fleets. And so, in 1494 in Venice we have the first treatise on bookkeeping.

The treatise was by a mathematician, Luca Pacioli (the spelling of his name varies), whose book *Summa de Arithmetica, Geometria, Proportioni et Proportionalita* included a section of 36 chapters on bookkeeping entitled "De Computis

et Scripturis" (Of Reckonings and Writings). Paciolo recommended the method of Venice. Three different accounting books were suggested. The first was a "memorial" in which one converted all the transactions to a consistent coinage (showing that foreign exchange translation problems did not originate with the FASB). The second was a journal to enter the converted amounts. The third was a ledger for posting. Other writers added to the literature on accounting and control in Venice in the following years.

Reference to England might have been mentioned before arriving at 1850—if only because it leads to the birth of our modern profession. Some authorities maintain that the English royal revenue was audited from the reign of William the Conqueror. But generally the establishment of the English Exchequer is assigned to the reign of Henry I (in 1100). Three independent records were maintained and were checked to each other at the end of the year. Originally they were audited by justices or barons (or their clerks) and later by official auditors. In England during the feudal ages auditors would travel on circuit to the manors and estates to check the accounting for disbursements and revenues. Indeed, there was a tradition that the best ale in the house was opened on such occasions. Whether or not this contributed to clean opinions is no longer known, but the beverages were referred to as "audit ale."

Some writers have argued that the stable financial controls in Elizabethan England can be attributed, in part, to auditors appointed by the Crown.

And that leads us to the 17th and 18th centuries and the growth of common law corporations in place of one-time joint ventures. Some of the bad speculative practices of this period led to the South Sea Bubble in 1720. During this period, therefore, the practice of accountancy developed further in order to accommodate the investigation of bankruptcies and other disasters.

Finally, we arrive at 1850—or perhaps more specifically 1844 with the passage of the English Joint Stock Companies Act. This Act provided for the appointment of auditors, though they were not independent. It generally ignored internal control, despite the earlier urgings of Paciolo, and during this period auditing was basically done on a 100% basis and was largely fraud-oriented.

By the early 1900's, the paper points out, auditors were still doing 100% checking for clerical accuracy plus some examination of internal documentary evidence. Testing was not used and little, if any, external evidence was examined.

Comparative Development of Thought on Internal Control in England and North America in the 20th Century

The authors refer to the growth of the control concept from 1905 to 1933. I think it might be interesting to compare the trends in the United States, England, and Canada during his period. During the early 1900's, the statutory audits in Canada and the U.K. led to 100% checking. However, by 1930, the concept of testing had begun, though little attention was being paid to internal control. A slight amount of external evidence was being examined.

Meanwhile, in the United States, audits were being performed not for statutory purposes but for credit-granting purposes. This led to the idea of the balance sheet audit as opposed to the clerical checking of Canada and the U.K. Subsequently, the idea of the balance sheet audit spread to Canada. At the same time

there was a move toward fairness of presentation. In 1913 and 1917 we have the advent of income taxes in the United States and Canada with the result of further emphasis being given to earnings. Then came the stock market crash of 1929 and following that more emphasis being placed on presentation, earnings, and the income statement as opposed to the balance sheet. In the 1930's with the formation of the SEC, the United States became, for those of us in Canada, the dominant influence replacing the U.K.

In 1934 we have the beginning of the examination of external evidence in any quantity. In 1939, the McKesson & Robbins case provided further impetus to these developments (I thought the quote in the paper on control was interesting here as we usually think of this case as just being related to inventory observation). Then in 1941 generally accepted auditing standards were called for by the SEC and in 1948 promulgated by the AICPA. I'm afraid in Canada, we did not arrive at a statement of generally accepted auditing standards until the 1960's at the provincial level and not until 1975 at the Canadian Institute level.

I think it's interesting to note that with the gradual addition of external evidence to Canadian auditing practice (following English precedents) and with the gradual addition of checking of transactions to U.S. auditing (in order to justify reliance on control) the two audit streams in North America moved together. Meanwhile, the U.K. also shifted from fraud detection to assurance of fair presentation with due reliance being placed on control. All these trends are difficult to assess in retrospect, as what historical writers now say and what actually took place may often be two different things.

I thought it was an interesting idea to follow the changing views in the successive editions of *Montgomery's Auditing*. I don't have any particular comment on this part. A lot of the material involves questions of semantics. Finally, with the 9th edition of *Montgomery's Auditing* in 1975 we are up to "where we are now."

Present Thinking on Internal Control and Internal Auditing

The 9th Edition of *Montgomery's Auditing* presents a more elaborate analysis of the components of internal control and I think this is useful. It has become now not just an excuse for reducing tests but something that auditors have decided they really must study in a systematic manner. With the AICPA Statement on Auditing Procedures No. 54, we have the introduction of the concept of compliance tests and with that another dimension was added. I might use these ideas as a jumping off point to discuss a few comments on internal control classification.

Internal Control Classification

Several different methods of classifying controls exist, some of which are suggested in the quotation from *Montgomery's Auditing*. Among the possible methods are:

1. By attest or non-attest significance.
2. By objective of the controls.
3. By accounting controls versus administrative controls.

4. By preventive controls versus detective controls.
5. According to the general nature of the control technique.

With respect to the attest versus non-attest significance, I think it is important to emphasize that internal control is primarily a management tool and only secondarily of audit use. It follows, therefore, that some controls will be important for management but have no influence on the auditor's work and some controls will be as good as it is practical for management to make them but still not sufficient to permit significant reliance by the auditor.

With respect to classification of controls by objective one could talk about safeguarding of assets, reliability of accounting records, the timely preparation of reliable financial information, profitability and minimization of unnecessary costs, the avoidance of unintentional exposure to risk, the prevention of detection of errors and irregularities, the assurance that delegated responsibilities are being properly discharged, and the discharge of statutory responsibilities by the management group. Of course, some of these objectives overlap. In any case, this matter of classification is not particularly helpful in analyzing control techniques since the same technique can often serve several different objectives. For example, perpetual inventory records independent of the storekeeper may help to (a) safeguard inventory, (b) ensure accurate inventory records, (c) detect inventory shortages, and (d) prevent irregularities.

The split of accounting controls and administrative controls has been in professional literature for some time. Originally, accounting controls were said to be related to safeguarding assets and influencing the reliability of financial reporting while administrative controls were concerned with promoting operational efficiency and adherence to prescribed management policies. However, some administrative controls affect the reliability of financial reporting as well. I confess I do not find it a very useful distinction. I rather think that the auditor must look at any type of internal control which could have a bearing on his expression of opinion on the financial statements.

The distinction between preventive controls and protective controls can be a useful one. The idea was incorporated in a recent Canadian Institute publication "Computer Control Guidelines" though no doubt it has been discussed many other places as well. Preventive controls prevent errors or reduce the chance of error occurrence. Detective controls detect errors or increase the chance of their detection. Of course, usually one must have both types of controls. Preventive controls are perhaps what the 9th Edition of *Montgomery's Auditing* refers to as disciplinary controls. One distinction between the two types of controls is their auditability. The auditor can observe preventive controls relatively easily, though it may be hard to evaluate their effectiveness. The operation of detective controls, on the other hand, is very difficult to prove. That they are operating when an error is caught is clear. But whether they were really operating in between the catching of successive errors is less clear. One can only assume that if another error had occurred it would have been caught but one cannot really prove that the detective control was functioning in those cases.

Perhaps the most useful method of analyzing internal controls from the auditor's point of view is by the general nature of the control technique. There are many different ways in which such an analysis can be made. One way would be as follows.

Organization controls may be said to deal with honesty and competence (hiring, supervision, training), segregation of functions (custodial versus reporting versus operating functions) and the overall plan of organization together with the accounting/financial organizational plan. *Systems development controls* deal with the development, approval and revision of systems—and must be considerably more formal in the case of computer systems. *Authorization and reporting controls* deal with authorization, comparison, validity checking, budgets, responsibility reporting, etc. *Accounting systems controls* deal with initial recording (document design), general ledger and account organization and balancing routines. *Additional safeguarding controls* cover things such as restrictive access, protection of records, periodic count and comparison, insurance, etc. *Management supervisory controls* deal with the personal supervision by management, the monitoring of controls and the detecting of errors, and the internal audit program. And finally, *documentation controls* cover manuals of policies and procedures and, in the case of computer systems, more elaborate documentation of systems and programs.

The Wagging Tail

Of the foregoing seven different types of controls, one can see that internal audit is but a part—though admittedly a very important part. I believe it is logical to view internal auditing as a part of internal control. It is the delegation of the management monitoring function to a separate internal audit group. I don't think one should view this as a tail wagging the dog. Indeed, in large systems the monitoring system may grow almost as complex as the system it monitors. But this is merely analogous to EDP housekeeping controls using up almost as much space as the actual working program they are controlling.

Conclusion

In summary, I thought the paper gave an interesting overview of the historical development. As in all overviews, it is something that could also be expanded—and indeed, might be of considerable interest in a more expanded form. The principal areas where some expansion might be of interest would be, as I have suggested, feudal England, Renaissance Italy, and the coming of Companies Acts to England, together with a comparison of the subsequent developments in the United States, England, and Canada.