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Functions and Responsibilities of the Internal Auditor

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This paper was the subject of a talk before the Detroit Chapter ASWA in February. We present, with pleasure and pride, an article packed with information which is valuable to both the public and the private accountant.

FUNCTIONS AND RESPONSIBILITIES OF THE INTERNAL AUDITOR

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Auditing is somewhat analogous to law in respect to the marketing of one's skill. As you know, some lawyers open up an office of their own, or join with others already in practice, and offer their services to the public. Other lawyers prefer to associate with private industry as legal advisors.

The person who has trained and specialized in auditing has a similar choice as to the field in which he or she will seek employment, i.e., enter the public accounting field or associate with private industry as an internal auditor.

Because the progress made by internal auditing during the past ten years has been greater than in any prior period, and is accelerating each year, I feel that there will be an increasing number of opportunities in this particular field as time goes on.

Nature of Internal Auditing

Current concepts of internal auditing are quite different from those of a few years ago. Objectives, scope of duties and responsibilities have broadened materially. Management is becoming increasingly conscious of the utility of internal auditing and is making far greater use of it than it has in the past.

In the days of the sole proprietorship and the small partnership, the owners took a very active part in the management of their business. Most activities stemmed from their directives and the main operating functions were under their direct control or supervision. There were, however, certain exposures that could not be controlled satisfactorily. The accounting and record keeping were largely hand operations performed by employes with little more than clerical qualifications; and the systems of internal control and internal check were of an elementary character. As a result errors were a common occurrence and misappropriations were comparatively easy.

This condition developed the need for someone with more than ordinary skill to follow along behind the constructive accounting to ferret out the many clerical errors and to detect any misappropriation of assets. This simple activity of policing company values and clerical routines was termed Internal Auditing.

In a way this was about all that was required, since the problems of management and administration were comparatively few, and proprietary management was in a position to exercise necessary controls. With the introduction and development of the corporate system, business enterprises grew in size and complexities to the point "owner" administration was impossible or inaffective. The owners or proprietors could no longer exercise that direct and personal control that was possible in the small business unit operated as a sole proprietorship or small partnership.

With the growth of the corporate system came the introduction of accounting and office machines, improved and intricate accounting systems, perfected systems of internal check and the employment of more skillful employes. These developments caused radical changes in audit requirements and a demand for a higher standard of practice on the part of the auditor.

Today, the size of most companies makes it impossible for the executives composing top management to exercise direct and personal supervision of the functions for which they are responsible. About all they can do is to formulate policies and procedures, and review and interpret reports on operations. They can no longer observe and participate in the multiplicity of detail transactions that flow through the records at a dizzy pace.

While the executive has bridged this ever-widening gap between his administrative position and the front line operations by surrounding himself with a corps of assistants and line supervisors, he nevertheless is operating by remote control.

It matters not how able his staff may be, nor how well the integrated pattern of management may be formed, defects and deterioration are sure to develop unless vigilant surveys and evaluations are maintained.

Recognizing that inspection of management functions and clerical routines is as essential as inspection on the production line, management utilizes internal auditing for the purpose of assuring itself that policies and procedures are properly and faithfully followed, that company values are adequately protected and conserved, and to secure the benefit of an independent and objective review and appraisal of its accounting, operating routines and other responsibilities.

The older concepts of internal auditing emphasized its objectives as:

1. The detection and prevention of fraud.
2. The detection and prevention of error.

Current concepts not only recognize these same objectives, but include many others which are considered of far greater worth to management. The number of instances of deliberate dishonesty or undetected clerical errors are few in comparison with the cases in which management acts on incomplete or inaccurate information; or the number of instances that the business suffers through waste, hazards, exposures, lack of internal check, ineffective controls, failure of delegated responsibilities and matters of this kind.

Present practice groups internal auditing objectives as follows:

1. Those which are essentially protective.
2. Those which are essentially constructive.

It is the rendering of those services that are classified as "essentialily constructive" that has caused internal auditing to be recognized as a tool of management.

The internal auditor who renders no more than "protective" services has not yet attained professional status; he is merely performing a clerical routine—a policing service.

The problems of business administration are becoming more numerous and complex with each succeeding year, with the result that executives at all levels are finding it necessary to parcel out more and more of their responsibilities to subordinates for execution.

In our larger companies this increasing need for decentralization of authority and a corresponding realignment of responsibilities has resulted in layer upon layer of subordinate management. For illustration:

1. Top management—
   (a) Proprietary management
   (b) Administrative management
2. Middle management—
   (a) Staff management
   (b) Operating management
3. Line management—
   (a) Department management
   (b) Supervisory management

And to this grouping might be added other subdivisions, as section management, group management, field management, branch management, plant management and many others.

Each management layer receives its responsibilities from its superior level and directs and coordinates the activities of management segments to which it has delegated a portion of the responsibilities received.

Tools of Management

Experience has proved that efficiency and par of performance are seldom obtained from delegated responsibilities. The factors of misinterpretation, carelessness, incompetency, procrastination, misunderstanding, neglect, poor judgment, and many other human weaknesses tend to defeat the desired objectives.

For this reason management has found it necessary to establish a system of internal controls which will assure that their policies, procedures and directives are faithfully and effectively carried out; that company values are adequately protected and conserved; that there has been a proper administration of functions delegated; that management information has been accurately accumulated and presented; that external regulations have ben complied with; and that matters requiring consideration are promptly drawn to attention.

The number of individual controls making up such a system, will vary, naturally, with the type of business, size of the company, and the requirements of management. As an example we have:

1. Budgetary control
2. Cost control
3. Production control
4. Cash control
5. Internal check
6. Internal auditing
7. Many others of a similar nature .

Each type of control has its own important part to play in the general scheme of management; and the most of them interlock with the general pattern of operations to such an extent that they become an integral part of it.

While "internal auditing" is one of the several controls maintained to serve management, it differs from most of the other types of control, in that it forms no part of the action phase of business. It supplements rather than complements the other controls, and functions largely as a protective and service agency.

In addition to functioning as a type of control for measuring and evaluating the effectiveness of other controls, internal auditing serves management by keeping it posted on the state of business by bringing to attention all material facts that might not otherwise receive consideration.

As previously pointed out the objectives of internal auditing may be classified under two general headings; those which are:

1. Essentially protective
2. Essentially constructive

The protective objectives comprehend the policing of such features as the following:

1. Company policies
2. Accounting and operating procedures
3. Systems of internal check
4. Care and storage of records
5. Care and storage of company values
6. Compliance with external regulations
7. Reliability of accounting and statistical data
8. Many other analogous functions

While the auditor is charged with a rather wide and varied type of policing service, including the detection of fraud and error, it is the constructive services he renders that enhance the value of his work.

The utility of a tool depends upon a complete knowledge of what the tool will do and the skill that is applied to that tool. This analogy is equally true in respect to internal auditing. The utility of internal auditing depends upon a comprehensive knowledge of what it can do for management, and the degree of skill the auditor is able to apply. The worth of internal auditing and its utilization by management are in ratio to the auditor's knowledge and his skill in the application of that knowledge.

To function at the management level as oposed to the clerical level, the auditor must possess more than mere technical knowledge. Too many persons concentrate on becoming good technicians without learning how to use their skill effectively. They develop their specialized technical skill far beyond the broad knowledge they need to support that skill.

What the average auditor needs more than anything else is a broader knowledge of his company's affairs and a better understanding of its problems and objectives.

The auditor must have a clear and comprehensive understanding of the entire structure of controls and checks which management has established, if he is to perform an effective policing service.

He should be familiar with the by-laws of his corporation, the minutes of stockholders' and directors' meetings, the extent to which the directors have delegated responsibilities to management, the general duties of management executives and the extent to which any of these duties have been redelegated to subordinates, and many other matters of a similar nature.

He should also be provided with a copy of the company's organization chart that he may be thoroughly familiar with the relationship of the various functional activities and know who is responsible for their operation.

In those cases where staff and department operating manuals are available, the auditor should be furnished with a copy for each activity in order that he may be well informed on their routines and procedures.

Copies of all policy letters and instructions relating to operating routines and procedures that may be issued by executives and department heads should be supplied to the auditor that he may be kept currently informed of any matters which affect his policing and service activities.

The auditor should be invited to sit in on all meetings of committees, executives, department heads and other groups which in any way relate to policies, procedures, reorganizations and other activities, in order that he may be as familiar as possible with management's thinking and objectives. Otherwise how can he serve this group to the fullest measure?

He should also be promptly advised of all important contracts, royalty and license agreements, expansion and rearrangement projects, construction programs and similar activities, that he may be prepared to give them the required attention.

He should be thoroughly familiar with the policies, procedures, and functions of such departments as the following:

a. Accounting
b. Financial
c. Purchasing
d. Production
e. Marketing
f. Salvage
g. Labor relations
h. Public relations
i. Other principal activities

The auditor should be a constant student of his company's business. The more he knows about its problems and objectives, the greater will be his worth. He should develop a management consciousness and perspective that will enable him readily to sense those matters that are of interest to those whom he serves.

It is only when internal auditing is established at the management level, headed by a highly capable director and staffed by competent personnel, that management can derive the maximum benefits from its service.

Organizational Types of Internal Auditing

There are four "organizational" types of internal auditing, and a failure to recognize this fact is, perhaps, the principal reason for the lack of a common understanding that frequently exists when people are discussing internal auditing. The objectives, scope of audit, and required standard of practice differ materially with each type. The four types are:

1. Proprietorship internal auditing
2. Management internal auditing
3. Staff internal auditing
4. Department internal auditing

When the internal auditor is appointed by, and reports to the owner of a sole proprietorship, the partners of a partnership, or the directors of a corporation (or the stockholders), and is completely independent of all other management personnel, he is termed a "proprietorship" internal auditor. His scope of activities is generally very broad and he is highly concerned with operating and management functions and their effectiveness.

If the internal auditor is appointed by the president, the executive vice president, the administrative or executive committee of a corporation, or other management authority of a similar level, and he is independent of all other personnel below these strata, he is termed a "management" internal auditor. Usually his duties and responsibilities will not differ materially from those of the "proprietorship" type. However, he is a representative of administrative management and not of proprietorship.

In those cases where the internal auditor is appointed by a vice president in charge of finance, the treasurer, the controller, or by some other staff head of relative rank, he is said to be a "staff" internal auditor. As such, he has no authority to function outside of the staff head's area of responsibility, except as his staff head may arrange with other staff managers. In addition the auditor is subject to the instructions, policies and dictates of his staff head. Generally he lacks the full independence and freedom of action enjoyed by a "proprietorship" or "management" auditor.

When a department of a staff or some other minor operating activity appoints an internal auditor to serve within the limits of that activity's responsibility, the auditor is termed a "department" internal auditor. Examples of ths type would be:

1. Disbursement auditor
2. Payroll auditor
3. Accounts payable auditor
4. Construction auditor
5. Branch auditor
6. Others of a similar nature

In respect to this type of internal auditing one must carefully distinguish between those department activities that are truly of an auditing nature and those activities that are merely a part of the system of internal check. We must make a clear distinction between "internal check" and "internal audit." "Internal check" is a control designed to function as an integral part of the accounting system while "internal audit" is a type of control created to function independently of accounting routines and procedures.

Internal auditing is a term that has been very loosely used, and has been applied to all types of verification work from simple clerical routines up the scale to the performance of complex assignments comparable to those of the public accountant. Consequently when we deal with this term we must be conscious of its wide connotations, and appreciate the need for clarification as to specific type.

In the absence of qualifications to the contrary, the term "internal auditing" is generally understood to refer to the "staff" or "management" type, and to comprehend both protective and constructive objectives.

Functional Types of Internal Auditing

In considering internal auditing, we not only have to recognize its organizational level but also its functional type. The objectives, scope of work, audit technique, style of reporting, and other details of operations will vary considerably with each functional type of auditing. The more common types are as follows:

1. Continuous audits
2. Feature audits
3. Perodic audits

Continuous audits may be classified as:

A. Pre-audits
B. Post-audits

Continuous audits of the pre-audit type are generally employed when it is desired to have all transactions independently verified before finalization. This form of auditing is performed largely by "department" internal auditors, such as disbursement auditors, accounts payable auditors and payroll auditors.

Continuous audits of the post-audit type differ only in respect to time of performance; the audit is usually carried out at the auditor's convenience following consummation of the transaction but before transfer of the related records to closed files.

Feature auditing consists of examining one phase of the program at a time; such as cash receipts, payrolls, plant accounts, et cetera. The program is so arranged that all features will be covered at least once each year, and some will be serviced two or more times depending upon requirements. This method is employed largely by resident internal auditors.

Contrasted to the feature auditing procedure just explained, the periodic audit covers all features for a definite period, at one time; this may be quarterly, semiannually, yearly, or at irregular intervals.

Period audits are generally applied when a company maintains operating and accounting activities at more than one location. Generally speaking, resident auditors perform feature audits while traveling auditors make periodic examinations.

When the "continuous" type of auditing is used, reports are usually rendered on a monthly basis; however, the frequency of reports should conform to management's requirements.

When the auditor is following a "feature" audit program, he should render his report upon completion of each major feature or group of related features. If his work schedule calls for periodic examinations, then his report should be submitted promptly upon completion of his assignment.

The type of auditing to be employed depends entirely upon organizational set-up and objectives to be accomplished. Internal audit systems do not come in stock patterns; they have to be specially designed to fit the needs of each particular type of business and management's requirements, if they are to be effective service agencies.

Whenever two or more people get together for a discussion of internal auditing, it is essential that they first define the organizational and functional types they have in mind in order that they may proceed from a common viewpoint.

Special Qualifications for Auditing

I believe it might be interesting and perhaps helpful to mention a few of the qualifications necessary to successful internal auditing.

A good fundamental education of high school grade, naturally, is a first requisite. While college training is not a necessity, it is of course a desirability. Broad training in business subjects is preferable to specialization, though one should major in accounting and auditing.

The subjects that are most important and highly necessary are those that many give little consideration, and this is not only true in respect to those training for auditing, but equally true in respect to those training for other professional activities.

The subjects that are so woefully neglected are—

1. Communications
2. Human relations

Ineffective communication is a universal weakness, but it stands out like the north star on a clear night, with those who have to express the product of their efforts by the medium of the pen. You will find auditors who can do an excellent job so far as performing an audit is concerned, but when their work is completed and they face the problem of rendering a formal report on their examination, they fall from the pinnacle of professionalism to the depths of an amateur. And I would like to emphasize that this weakness is not limited to auditors alone. The most striking defect in the average professional man is his inability to convey his thoughts, correctly, clearly, concisely, courteously, and with character to his composition. These are the five C's of report writing.

During the past year I have talked with many directors of auditing staffs and they all tell me that their biggest problem is to find auditors who can construct a satisfactory report.

While I feel it is, primarily, the individual's responsibility to qualify himself in this important subject, I also feel that our schools and colleges have been extremely backward in developing effective courses in communication.

Human relations is another subject that few persons have mastered sufficiently to use it effectively. Superior contact ability is a quality that most executives seek in filling important positions. It is a qualification that is essential to successful auditing since the auditor's work involves conferences and interviews with all strata of personnel from the president of a company down to the office boy and factory worker.

A person with a pleasing personality, highly effective in human relations, and possessing a superior ability in communications, already has 70% of the necessary requirements for success, whether it be in auditing or some other professional activity. As important as technical knowledge may be, and it is important, very important, it constitutes only about 30% of the qualifications necessary for more than mediocre success.

The auditor with good technical training and experience plus a superior ability in communications and human relations is always in demand at an attractive salary.

TAX NEWS (*Continued from page* 5)
tracts or the patents were the income-producing property, and held that the decisive question was whether the taxpayer had retained sufficient power and control over the assigned property to make it reasonable to regard him as the owner of all rights which he had prior to the assignments and the real recipient of the income. *Joseph Sunnen, U. S. Sup. Ct., April* 5, 1948.

The decision leaves undecided what the result would have been if the license agreement had been an exclusive one with a completely independent corporation. If the patents were held to be the income-producing property, the royalties would be taxed to the husband on the ground that there had been only an assignment of income.

* * *

Heloise Brown has sent us a copy of a bulletin published by the Investment Bankers Association of America calling attention to the fact that the Bureau of Internal Revenue has recently modified one of the provisions of I.T. 3828, issued in December, 1946, which held that "a dealer in securities may treat as capital assets, as defined in Section 117(a) (1) of the Internal Revenue Code, securities acquired for investment purposes, provided it is established . . . (1) that such securities are acquired and held for investment and are not part of those held for sale to customers, and (2) they are not of a type ordinarily sold to the dealer's customers."

It was the second clause that worked a hardship on firms which have been both dealers and investors in the same type of securities, and which had actual or potential gains in their investment portfolios.

On February 23, 1948, the Bureau issued I.T. 3891, modifying I.T. 3828 by now ruling that "where securities are acquired and held by a dealer in securities solely for investment purposes, such securities will be recognized as capital assets . . . even though such securities are of the same type or of a similar nature as those ordinarily sold to the dealer's customers."

CONGRATULATIONS TO DOROTHY OTTOWAY

The May issue of the *Mid Western Banker* contains a news item about the appointment of Dorothy Ottoway, C.P.A., a member of AWSCPA, as manager of the credit department of the Marshall & Ilsley Bank, Milwaukee. Miss Ottoway has been with the bank since her graduation from the University of Wisconsin in 1938.