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THEORY AND PRACTICE

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REPORTS ON INTERNAL CONTROL

The Committee on Auditing Procedure of the American Institute of Certified Public Accountants issued Statement on Auditing Procedure No. 49 on "Reports on Internal Control." The Statement is to be part of a project for issuing a comprehensive pronouncement on internal control and deals mainly with whether the public interest would be best served by issuing a report on the auditor's evaluation of internal accounting control directly to the general public.

After discussing conflicting views, the conclusion of this Statement is that the decision properly belongs to management or, in some cases, to regulatory agencies as to whether such reports are to be issued. The Statement also sets forth the form of report which should be used when it is decided that such a report is to be issued.

Since independent auditors are sometimes requested to furnish reports on their evaluation of internal control, the purpose of this Statement is to improve the understanding of such reports. The Statement is to serve as a supplement of Chapter 5 of Auditing Procedure No. 33, which also deals with internal control.

Nature and Effectiveness of Internal Control

A definition of internal accounting control, as distinguished from administrative controls, is given and a review is made of the cost of such a system as opposed to the benefits to be derived. The limitations on any system of internal control are recognized; for example, poor instructions, errors of judgment, carelessness, or other personal factors. Likewise the effectiveness of the best procedures will depend on such items as proper segregation of duties, management errors respecting execution and recording of transactions, and errors during the preparation of financial statements which might reflect poor judgment or estimates. Even though internal control may have acted sufficiently in the past, there is a risk that in future periods changed conditions may make procedures inadequate or that compliance with the procedures may deteriorate.

Auditor's Study and Evaluation

The auditor evaluates internal control in order to determine what reliance can be made thereon and the effect internal control will have on the nature, timing, and extent of audit tests. Internal control is usually divided into (1) Accounting controls, which bear directly on the reliability of financial records and require evaluation by the auditor and (2) Administrative controls, which ordinarily relate only indirectly to financial records and therefore do not require evaluation. Certain administrative controls may, however, have an important bearing on the reliability of the financial records, in which case the auditor must consider the need for evaluating such controls. The concept of accounting control adopted for this Statement includes "any administrative control procedures that have been evaluated by an auditor because he believed they had an important bearing on the reliability of the financial records." The auditor's evaluation of accounting control must include, of course, the review of the system and tests of compliance. And the auditor's review and tests of internal accounting control should be recognized as only a part of his examination of financial statements.

Usefulness of Reports on Internal Control

It is evident that reports on internal accounting control can serve a useful purpose for management, regulatory agencies, and other independent auditors. Management is, of course, responsible for establishing and maintaining internal controls. Regulatory agencies may also consider it relevant to their primary purpose or their examining function. And other independent auditors may be concerned with internal control because it concerns their scope of examination. Each of these groups include persons whose experience or knowledge provides an understanding of the nature and effectiveness of internal accounting control and the auditor's evaluation of it. So it is evident that reports on internal accounting control can serve a useful purpose for these groups.

In contrast to these groups, however, it is questionable whether reports on internal accounting control would be useful to the general public. Whereas the foregoing groups are in a position to take direct action as a result of such reports, the general public can take only indirect action—on the financial statements or the company's management. The conclusion is reached therefore that reports on internal control to the general public:

1) would not provide additional credibility to audited statements,
2) would result in unwarranted reliance on financial statements if there was improper understanding of the limitations on the system of internal control or, conversely, that unduly negative inferences would result from improper understanding that weaknesses in controls could cause statements to be misleading, or
3) such reports might result in distorted appraisals of management performance.

After considering these conflicting views, the Committee concluded that the decision as to whether reports on the auditor's evaluation of internal accounting control would be useful for the general public in particular cases is the responsibility of management or regulatory agencies having jurisdiction. But, the Statement points out, the auditor should never report on his evaluation of internal control to the general public in a document that includes unaudited financial statements.

Form for Reports

If such reports are to be issued, the Committee believes the risk of misunderstanding can be reduced by adopting a form report that describes in detail the objective and limitations on internal controls and the auditor's evaluation of it. The language of the report to be used would, in this editor's opinion, be incomprehensible to the general public for it enumerates in rather technical terms the purpose of review of internal controls and the basis for reliance thereon by the auditor. Then it points out the limitations on such controls that might result because of changed conditions, errors in judgment, misunderstood instructions, etc.

The Committee recognized that suggestions or comments concerning specific aspects of internal accounting controls are often submitted to management as a result of observations made during examinations of financial statements, and encourages the continuance of this practice. But such informational communications should be restricted to matters on which the specific comments are directed. No overall assurance is to be expressed on other aspects of a system of internal accounting control unless the prescribed form is used.

If the report is the result of a special study (such as a study relating to an existing or a proposed system) the comment in the preceding paragraph holds true that, if such reports express any overall assurance on the system of internal accounting control, the form prescribed should be used with only such modifications as are necessary to describe the purpose and scope of the special study or a restriction indicating any special weaknesses noted.

THE INVESTMENT TAX CREDIT

When the investment credit first became available in 1962, it touched off one of the noisiest debates to hit the accounting profession in many years. The credit was a relatively new idea to most members at that time, and many suggestions were proposed as to how the credit should be reported in financial statements. Some took the position that the credit (which originally had to be deducted from the purchase price of the property before depreciating the balance, but which was added back to the cost a year or so later when the law again changed) should be taken into income over the life of the property. Others insisted that the credit should be reported as income in the period in which the credit "vested;" that is, when the credit would not have to be repaid even though the property was disposed of. For equipment with an eight-year or longer life, this resulted in the credit being picked up one-third at the end of each of the fourth, sixth, and eighth year of the asset's life. Still others demanded that the credit be taken to income immediately. Perhaps a bit late, the Accounting Principles Board of the American Institute of CPAs attempted to settle the matter by issuing its Opinion No. 2, but the desired result was not achieved. A little later the Board altered its position, which was set forth in Opinion No. 4, and the arguments gradually receded.

Debates on the subject disappeared entirely, of course, when the investment tax credit was repealed. Now that the Revenue Act of 1971 again provides for such a credit, we may once more find that the proper method of accounting for the credit is not entirely clear. The Accounting Principles Board, in what was possibly an attempt to take action before those members in practice would be forced to make some decision of their own, issued an exposure draft on the matter very shortly after the House version of the credit (sometimes referred to as the Job Development Investment Credit) was passed. The Board stated its intention to

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charge slips at the time he received his monthly bills whether the entertainment was business or personal. The CPA submitted a list of the persons for whom the expenses had been incurred, but the list was not admitted as evidence because it had not been contemporaneously prepared. It was admitted as testimony. The Court recognized the fact that CPAs and other professionals cannot advertise and must therefore participate in socially-oriented organizations as an aid to securing clients. But, the Court did not find that it necessarily follows that the expenses so incurred are business rather than personal.

The taxpayer then contended that the expenses should fall within the business meal exception to Section 274(a), but the Court cleverly surmised that "the circumstances normally attending the '19th hole' and the 'gin rummy table' cannot be regarded as the type of circumstances generally considered as conducive to business discussion."

A manager of a weekly magazine ran into similar difficulties with entertainment expenses, although he had maintained a personal cash diary. The taxpayer was also a playwright and claimed some entertainment expenses in connection with these activities. Only the expenses incurred in connection with his employment on the magazine were disallowed under Section 274(d). Although the taxpayer submitted account books which documented on a daily basis his expenditures, the account books did not specify the place of the entertainment, the business purpose, or the relationship of the persons entertained to the magazine for which the taxpayer worked. The oral testimony did not correct this situation. This case points out that oral testimony may be used to substantiate deductions, but there should be some testimony by a witness other than the taxpayer. (*Norman E. Kennely*, 56 TC No. 72)

A review of these decisions indicates that the documentary evidence used to support entertainment and travel expenses must be contemporaneous, and it must be complete. Many taxpayers are guilty of making the briefest notes on an American Express ticket or desk calendar, and trusting to memory the business purpose of the meeting or the business relationship of the person entertained. But trusting to memory such important details is not going to satisfy the Tax Court, and legitimate deductions may be lost.

It is also important in documenting the use of clubs, boats, and other facilities to document the personal use of such items sufficiently to clearly establish that the facility was used more than 50 percent of the time for business purposes. Otherwise, business deductions for club dues, boat operating expenses, and other such maintenance-type expenditures are not going to be allowed even though charges for specific occasions may be allowed.

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take into consideration any changes in the provisions of the law as finally enacted that might differ substantially from the provisions of the House bill. This exposure draft (dated October 22, 1971) required that the credit be used as a reduction of income tax expense over the periods in which the cost of the property was charged to income. This is a reflection of the Board's view that the credit is in substance a reduction of the cost of the property that results in the credit. Further, the "tax credit is not viewed as resulting in a reduction of income tax expense prior to the time the cost of the related asset is charged to income."

Subsequent to the issuance of this exposure draft, the Senate-House conference committee reached agreement that may have a great influence on the eventual treatment of the credit. For this committee included in the law a provision that, for purposes of making financial reports to Federal agencies, the taxpayer may account for the credit either currently in the year in which the credit is taken as a tax reduction or ratably over the life of the asset. Whether this provision in the law was intentionally included as a means of overruling the Accounting Principles Board is not known. Nor is the outcome of the matter in sight at this time. The conference committee report included the statement that their decision "included not only reports made to the Federal Government, but also reporting to stockholders to the extent any Federal agency has the authority to specify the method of such reporting." Once a method is selected, the same method must be followed consistently unless permission to make a change is secured from the Treasury Department.

Once more, therefore, we are faced with two authoritative sources expressing differing views on the subject. At the time of going to press, the matter is not settled, and this editor would not presume to predict which view will ultimately prevail. Readers are cautioned to make inquiry before attempting to apply the credit in their own financial reporting.