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Internal Control from the Viewpoint of the Auditor

BY FRANK G. SHORT

DURING the year 1939 the American Institute of Accountants developed a new model "short form of independent certified public accountants' report or opinion" to replace the one previously in common use. This model report in its present form was published by the Institute under date of October 18, 1939. The paragraph in this model report which deals with the scope of the examination reads in part "We . . . have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate." Many practising accountants (myself included) are, now that the busy season has ended, devoting a good portion of their time to a thorough review of their present auditing methods. In the course of this review they meet for the first time the positive statement in their customary reports that they "have reviewed the system of internal control" and a number of practical problems arise in determining the implications of this clause. What is the purpose of this review? What form should it take and how extensive need it be? What form should the auditor's working papers which record his investigation of the subject of internal control take? What is the "appropriate" extent of the examination or testing to be done in connection with the review of the system of internal control? It is the purpose of this article to express my views on these subjects. As a basis for my conclusions, however, it is first necessary to review briefly the historical development of auditing methods.

Auditing methods as first developed in Great Britain and later extended to the British Dominions and the United States were wholly based upon the concept of a detailed audit. Having received my early training in detailed auditing, I think I can briefly describe the detailed auditor's work. He verified, by reference to original vouchers so far as possible, all entries in the original records; checked, or substantially tested, all footings or recapitulations in these original records; checked the postings therefrom to the general ledger (and sometimes tested them to the subsidiary ledgers); and footed and balanced the general ledger. This detailed examination was ordinarily made at monthly or quarterly intervals and in the course of his work the detailed auditor devoted a not inconsiderable amount of time to investigating the possibility that there might be transactions which had never been entered upon the books. In fact, he regarded this as the greatest risk, since his methods were such as to insure reasonable accuracy after a transaction had been recorded. Having finished this work, the detailed auditor was disposed to assume that the resulting trial balance was correct and he therefore devoted but little time to proving that the results shown by the accounts were correct. After all, he argued, since he had investigated every entry in the accounts and had devoted considerable time to investigating the possibility of the non-entry of transactions in the accounts, the results derived from the accounts must be correct. I do not mean to imply that he devoted no time to an independent examination of these results. He did, but it was of distinctly minor importance and it was directed principally towards such items as inventories and other year-end adjustments which were incapable of proof from the accounts kept during the year. The detailed auditor conceived that the objectives involved in his work were (a) the discovery of fraud and (b) the discovery of errors, whether of omission or commission. Thus, it may be seen that the viewpoint of the detailed auditor as illustrated by the work he did was constructive (in the sense that he was concerned with the construction of the accounts) in its viewpoint rather than analytical.

When auditing was first introduced into the United States, the early practitioners were largely British trained and they naturally adopted the viewpoint and methods of the detailed auditor. These were shortly found, however, to be unsuitable for American business conditions. I need not elaborate upon the nature of the conditions which forced changes in methods, but they were such that in many cases the detailed audit was found to be unduly expensive for the benefits derived from it and, consequently, there was a demand for a reduction in the quantity of auditing work done. At first this did not result in any change in the auditor's viewpoint. Rather he retained the concept (and methods) of the detailed auditor but elaborated this concept to incorporate the principle that, in most cases, it was not necessary to make a detailed examination of every entry, footing, and posting during the period in order to get the substance of the value which resulted from an audit. This proposition was entirely sound, and American auditors developed the technique of substantially testing the entries, footings, and postings for selected months of the year, assuming that if these were found to be correct the remaining unaudited months could reasonably be presumed to be correct. In other words, the second phase of the development of auditing retained the viewpoint of the detailed auditor, but resulted in a less total quantity (and cost) of detailed audit work.

From the test audit to our present common analytical examination (the so-called "balance-sheet audit") was a natural transition. History does not record what accountant it was (although he no doubt existed) who, having verified the transactions in the prepaid-insurance account for a portion of the year, decided to satisfy himself as to the remainder by analyzing the insurance policies in force at the end of the year to determine whether the balance in the account was correct. Whoever it was, he gave birth to what was then an entirely new concept in auditing, namely, that the results shown by accounts were capable of a substantial degree of proof without the necessity of auditing the individual transactions which produced the results. This new concept was so valid and so well suited to American conditions that the idea developed with extreme rapidity. More and more emphasis was laid upon the analytical approach to the results and less and less upon the remaining features of the detailed audit, until finally detailed audits and test audits almost completely disappeared from our practice. This almost complete transition was unfortunate, for it resulted in the discontinuance of detailed or test auditing in many cases where it might well have been continued. I refer to smaller concerns where the facilities for internal control are lacking. In any event, the result is that a new generation of young accountants has grown up under surroundings which result in their having little appreciation of the original point of view of the detailed auditor which, even though it has been lost sight of, still has some validity.

Now let us consider the adequacy of our common auditing methods prior to such changes as may have been made in them as a result of recent developments. Some fourteen years ago I had occasion to make a quick change from detailed audit methods, to which I was accustomed, to balance-sheet audit methods. This sudden change naturally caused me to contrast the two methods. At that time I formed the opinion, which I have not since changed, that the balance-sheet audit was very effective, particularly in view of the less amount of time which it involves. In my judgment, the use of balance-sheet audit methods resulted in the discovery of approximately 90 per cent of the errors which would ordinarily be discovered in a detailed audit and this 90 per cent generally included all of the more important errors. In addition, the balance-sheet audit tended to reveal certain types of errors which the detailed auditor was apt to overlook. However, the balance-sheet audit is practically useless in detecting fraud, or in detecting certain types of errors of omission. This latter drawback had been recognized, however, by the profession, with the result that the business public appears today to be well educated as to the natural limitations of the balance-sheet audit. Reasonably well informed businessmen today do not look to the auditor for the discovery of fraud or the limited number of errors of omission which could only be discovered as a result of a detailed audit. Such businessmen recognize that proper methods of internal control within their own organizations must be looked to for the performance of these functions.

It is true that during the period surveyed above, the most capable accountants have continued to give some thought, as a regular part of their work, to the effectiveness of the methods of internal control in use in their clients' offices. However, I believe the profession should frankly recognize that this has not been general and that the recent inclusion of the statement, "We have reviewed the system of internal control," in our customary reports raises the necessity for a marked change in procedure to most accountants. In fact, I would hazard the guess that the committee of the American Institute which designed the model form of short report included this clause, at least in part, with a view to forcing an extension of our present methods. What does the inclusion of the statement mean? What can it mean unless it means that we have reviewed the system of internal control with a view to determining its adequacy (a) in revealing fraud, if it exists, and (b) in revealing those errors which are not discovered by balance-sheet auditing methods. In other words, we are returning in part to the viewpoint, if not the methods, of the detailed auditor and we must approach what is to many a new responsibility with the constructive viewpoint of the detailed auditor. We are concerned, as was the detailed auditor, with (a) the proper recording of the individual transactions during the period and (b) the question of whether or not all transactions were, in fact, recorded. We must look to methods of internal control to furnish reasonable assurance that these results have been achieved and if, in our judgment, this reasonable assurance does not exist, then we are forced to make some further investigation of those phases of the routine accounting work where the internal control appears to be inadequate. In this further investigation, it appears to me that we must adopt the methods of the detailed auditor and make such tests as are necessary to satisfy ourselves. Nothing less can be said to be "appropriate."

What is "reasonable assurance" as the term is used in the preceding paragraph? Obviously, this must rest upon the judgment of the auditor in each individual case, such judgment being exercised in the light of customary professional standards. It certainly involves less obligations than would be involved in a detailed audit for we only state that we have made a review of methods, coupled with the definite limitation that we have not made a detailed audit. It therefore goes without saying that our responsibilities could under no circumstances be greater than those of the detailed auditor. This point is made particularly in connection with that phase of the work which is concerned with the adequacy of the methods of internal control in revealing fraud if it exists. Even the detailed auditor never represented that he could discover all types of frauds and his natural limitations were recognized in law. While available time does not permit me to document the statement, I believe I am correct in saying that numerous British cases have held that the auditor is bound to follow up any matter in which his suspicions are aroused, but that he is entitled to accept the recording of transactions as correct if nothing arouses his suspicions. I believe the courts have also recognized that he has no responsibility beyond that reasonable degree of skill which he, as an accountant, could be expected to possess. For instance, a detailed auditor presented with an invoice for the purchase of goods, complete and regular in every way, would pass the entry for the purchase as adequately vouched. Nor would the later discovery that the vendor had bribed the purchasing agent in connection with the transaction reflect in any way upon the auditor. In other words, this is an instance of a type of fraud which cannot be discovered with that reasonable skill which the average accountant is expected to possess. Consequently, in the review of the methods of internal control as to their adequacy in revealing fraud we are not bound to consider every conceivable type of fraud but only those types of fraud which are capable of reasonable control through the medium of accounting methods. Types of fraud which lie beyond this limitation never were, and are not now, within the scope of our work. Space does not permit an enumeration of the types of fraud which adequate internal control may be expected to reveal.

It may be wise at this point to consider precisely what is meant by the term "internal control." I think it may be said that the term is broad enough to include all methods in use within the client's own organization which tend to insure accuracy in the accounting records. Such methods may be classified into four groups:

1. Internal audits.
2. Methods which involve the division of responsibility.
3. Methods which involve the principle of accountability.
4. Methods which involve publicity.

Running through all four classes one finds the principle that the most effective preventive of dishonesty is the fear of discovery. Detailed auditors recognized this principle and commonly took the attitude that their work was of more importance in preventing fraud than it was in discovering it.

In the case of larger clients, particularly those with branches, we may find an accountant acting as internal auditor and having no duties in connection with the keeping of the records. He will usually perform his auditing function in much the same manner as did the detailed auditor. Not infrequently, he will have other functions, such as scrutinizing the granting of credit at branches. From the public accountant's viewpoint, assuming the internal auditor to be competent, this is the ideal situation. The public accountant need only request that the internal auditor keep a written record of the work he has done and that he prepare written reports, if he does not already do so. These records should enable the public accountant to form a fairly quick judgment as to the adequacy of the methods of internal audit.

Methods of internal control which

involve a division of responsibility are based upon the distribution of the work of the staff in such a manner that in as many fields as possible the work of one employee tends to check the work of another. Such methods are obviously more possible in a large organization than in a small one. Methods of this type obviously tend to minimize the risk of undiscovered fraud and errors. However, if the ideal result is to be achieved, careful planning of the accounting system and the routine of handling transactions is essential, and this is a subject too extensive to be dealt with in this article. Even within the field covered by such methods undiscovered fraud may exist, but only as a result of collusion between two or more employees.

In so far as it is possible, complete accountability for assets should be placed upon the shoulders of specified individuals. This involves the principle of charge and discharge. A simple illustration would be the case of a vendor of theatre tickets who is responsible either for the unused tickets or for their equivalent in cash. Methods using the principle of accountability could probably be used to a greater extent than they now are.

Another group of devices embodied in the term "internal control" depend for their effectiveness upon publicity. The common cash register is a simple illustration. The effectiveness of the cash register is based upon the assumption that failure to "ring up" a sale will be noticed by the customer or others who may be present and hence may come to the ears of the management.

From the above description one might be pardoned for coming to the conclusion that effective methods of internal control are possible only in business enterprises of some substantial size. However, this common misconception is erroneous, for a little study will point to the possibility of some quite effective methods of internal control even in a small concern having but a single bookkeeper. One example occurs to me which arises from my early experience in detailed auditing. In smaller concerns which paid wages in cash and where no other means of vouching the items on the payroll existed, it was our custom to ask the manager (who was usually the owner) to review the payroll each week and sign it. This is a very effective check against payroll padding, for in such concerns the manager usually has an intimate personal knowledge of who his employees are and approximately how much they should be paid. Of course, it does not prove the footings of the payroll and defalcations might still be hidden by an overstatement of the payroll total accompanied by the drawing of a check payable to cash for the overstated total.

Another method of internal control applicable in a small concern is possible if the owner-manager can be persuaded to sign checks only upon the presentation of properly approved vouchers. He should, of course, initial the vouchers in ink or otherwise mark them so that they cannot be used to support a second check. In other words, if those who sign checks can be persuaded to take this duty seriously instead of signing them perfunctorily, indeed without looking at them as so often happens at present, then we have established a quite effective method of internal control.

Without in any way attempting to exhaust the possibilities of effective (although not necessarily complete) measures of internal control in a small business, I will give one more illustration. Certain types of fraud depend for their success upon manipulation of customers' accounts receivable, or upon the creation of "dummy" accounts with a nonexistent customer. If the owner-manager of a small business will make a practice of reviewing the accounts in the accounts-receivable ledger at regular intervals for the primary purpose of watching credits, this review will serve as an effective check against fraudulent manipulation of the accounts receivable.

It should be made clear at this point that there are no methods of internal control which are in all circumstances effective against fraud by a management which is itself dishonest. The reason for this is obvious. The entire principle of internal control is based upon the assumption that the management is anxious to prevent fraud and all such methods are designed to bring fraud to the attention of the management should it be discovered. The recent Coster-Musica (McKesson-Robbins) frauds represent a case in point. While I have not read a complete account of the manner in which these frauds were accomplished, nevertheless I gather from newspaper accounts that the company's own accounting organization was deceived by the clever picture presented by the fraudulent management.

I have said little to date on the subject of internal control as an effective method of revealing errors not accompanied by fraud, although I mentioned earlier in the article that there were certain types of errors of omission which are not revealed by the balance-sheet audit. An instance would be the failure to record a shipment of goods to a customer as a sale in the books of account. Obviously, such an omission might represent the first step in a fraud, namely, the embezzlement of the remittance from that customer, or an amount corresponding to the remittance. However, it is apparent that the omission might also represent a mere oversight and this is the type of error which would seldom, if ever, be discovered by balance-sheet auditing methods. Methods of internal control could be designed which would effectively prevent this type of error, whether it be fraudulent or innocent.

Let us now consider the methods to be used by the auditor in his review of the system of internal control. I have already pointed out that his viewpoint and objectives must be different from those which are present when he performs a balance-sheet audit. But, it appears to me, his methods may be the same. In other words, he will use the methods of inquiry and investigation to whatever extent seems necessary, but he is entitled to the assumption that the information he receives from the officers and employees of the client is truthful, at least until such time as something occurs which causes him to doubt the truth of such information.

The methods of organizing the auditors' working papers, in so far as they deal with the subject of internal control, will naturally vary according to the practices of each firm of accountants. However, I suggest the following as an applicable method. Many accountants now keep what is known as a "permanent" working-paper file for each of their clients. This file includes notes and memoranda which are of continuing importance, rather than of importance only to the year under examination, such as extracts from by-laws, bond indentures, etc. It appears to me that the basic review of the methods of internal control properly belongs in this file, since it is of continuing importance.

The original review should take the form of a clear statement of the methods in use and the opinion of the auditor as to their effectiveness, together with notes of phases of the accounts which are not subject to proper internal check and which, therefore, must be tested by the public accountant. Sufficient space should be left after each section of the review to provide for notes of changes. It should be a part of the duty of the auditor at every annual examination thereafter to review the original notes with a view to discovering changes, if any have been made. The annual working papers should contain, in a separate section (not mixed in with the working papers covering the balance-sheet audit), a record of any tests which the auditor has made during that year with a view either (a) to proving the effectiveness of methods of internal control about which he is doubtful, or (b) to testing or verifying the recording of transactions in those fields in which internal control is lacking.