

Internal Control, Internal Auditing and Effect on Audit Program

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THESE have been numerous definitions propounded for "internal control" and since it is not the purpose of this discussion to arrive at the perfect definition, if one could be obtained, it will suffice to describe it generally as a form of procedure within an organization which offers a method of checks and balances to the extent of discouraging theft, promoting accuracy and reliability of the accounting data, and developing general operational efficiency. To the extent that such control accomplishes these ends, it follows that the necessary review by the independent auditor is lessened. His certain "musts" in auditing (as, for example, confirmation of bank balances, examination of securities, confirmation of accounts receivable, etc.) cannot be eliminated, but the extent of his tests may be minimized, especially insofar as they concern operations. In fact, the existence of a substantial degree of internal control is what makes possible the successful conclusion of independent audits of very large concerns. The accounting regulations of the United States Se-

curities and Exchange Commission explain this point:

"In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed."

The role played by the internal auditor in maintaining control procedures will be discussed in a subsequent paragraph.

Evaluating Effectiveness of Internal Control

In evaluating the extent of internal control some certified public accounting firms employ questionnaires several pages in length. In such instances it is concluded that the questionnaire form is so inclusive that where all questions appearing therein are answered satisfactorily, the system of control is complete. Other firms do not use specific questionnaires but have the system of control evaluated by the senior accountant during the course of his examination. Should he observe laxity in control, or shortcomings in procedures, he will note completely the shortcomings and will not specifically write up the procedures for control where they do exist. The danger in the use of the questionnaire alone, without continued observance during the course of the audit, is that practices, although answered in the affirmative in the questionnaire as the result of questioning the concern's employees, may be entirely different in actual operation. In any event, the evaluation of an internal

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control system should be done by an experienced and well trained accountant. It should not be delegated to assistants.

The Internal Auditor in Internal Control

The place of the internal auditor and his staff in the development and maintenance of internal control is of especial importance. In fact the internal auditor is an integral part of the entire internal control system. A special report entitled "Internal Control", issued this year by the Committee on Auditing Procedure of the American Institute of Accountants includes the following on the internal auditor's function:

"An internal audit staff may be used not only as a check on the accuracy of the accounting data and the safeguarding of the company's assets, but also as an instrument of management in determining adherence to prescribed policies. Thus, the audit activities should be widespread, covering all departments."

Adherence to prescribed policies refers to the maintenance of procedures which in themselves are a part of internal control. The report continues:

"The review and appraisal to be useful to management must be unbiased—free from any departmental influence as to the scope of the audit program and the method of reporting thereon. The internal auditor should be free to advise management of any deficiencies noted, without fear of reprisal from any department heads. His relationship to the department head should be clearly set forth by management to avoid any misunderstanding as to their relative positions. Under such conditions the internal auditor is in a position, without any limitations, to serve management in the detection of frauds, weaknesses in procedures and in the clarification of policies on a company-wide basis.

"In many instances, while the size of the organization may warrant segregation of the internal audit function, the economic employment of personnel of the quality compatible with complete independence may not be practicable. Under such conditions the question often arises as to the propriety of incorporating the internal audit function into the sphere of the controller. An arrangement of this sort is generally regarded as satisfactory, assuming inde-

pendence of the accounting and auditing function at the next lower level."

This emphasizes the need for independence in review and the maintenance of greater than arm's length relationships with other employees. The fact that the internal auditor and department head both serve the same concern makes it difficult to make uninfluenced criticisms. Lunching together, attending parties together, etc., further contributes to non-independence. However, it is not impossible for the internal auditor to maintain a constructive, impartial and critical attitude. Educating executive and administrative employees as to the benefits of constructive reviews of their departments as an aid to the promotion of efficiency does help. Rotation of internal auditors, the assignment of auditors to other than their home plants, and other techniques are employed to promote maximum independence.

Independent Auditor's Reliance upon Internal Auditor's Review

After concerns have gone to great length to establish and maintain internal auditing departments, some complain that the independent certified public accountants do not give full recognition to their reviews, do not adjust their programs accordingly, and do not avail themselves of their compiled information. There is something to be said on both sides of this question. The Institute of Internal Auditors, Inc., New York City Chapter, in a recent news bulletin stated the position of the internal auditor as determined from a questionnaire sent to its membership:

"Perhaps the most disappointing replies received were those relating to the inter-relationship between public accountants and internal auditors. There are many leading firms and individuals in the field of public accounting who still either do not or will not recognize the role of internal auditing.

"The question was asked: 'Does a close working relationship exist between your company's Internal Auditor and its Public Accountant?' One hundred and five companies answered this question, and of these

22 answered in the negative. This failure is believed to be due largely to a lack of understanding of modern internal auditing on the part of men in the public accounting profession. The Institute of Internal Auditors should take active steps to correct this situation."

Perhaps we as certified public accountants should take the initiative. The bulletin continues:

"This question was asked: 'In the opinion of your company's Public Accountant, could he issue an unqualified certificate if the company did no internal auditing?' The direct answers were divided almost 50-50 between Certified Public Accountants who said they could issue an unqualified certificate and those who said they couldn't if there was no internal auditing in a given company. Does this mean that the Certified Public Accountants answering in the affirmative do more work than is really necessary in companies having internal auditing staffs? Or, and this appears more likely, does it mean that these Certified Public Accountants fail to understand just what work is performed by the internal auditors? Internal auditing is an essential factor in internal control in any large or complex company, and if this function is not performed, the certificate ought to be qualified to reveal the fact that the system of internal check and control is not complete."

As previously stated, the existence of internal auditing and other procedures for internal control make possible the audit of very large concerns, and enable an unqualified certificate to financial statements to be issued.

Coordination and cooperation between the independent auditor and the internal auditor is much to be desired. It is born of an appreciation of each other's functions and a cooperative spirit in the solving of respective problems. In order that the independent auditor may place the maximum reliance upon the effectiveness of the reviews made by the internal auditor, the internal auditor's program of audit should be developed in close cooperation with the independent auditor, giving the latter an opportunity to criticize constructively where he believes reviews are inadequate or procedures lacking. The internal auditor's program, when once established and used,

should be maintained as a permanent record, including in it the dates when specific reviews were performed and the initials of the internal auditor who did the reviewing. The internal auditor's reports and working papers should be offered to the independent auditor for his information or use. Where the independent auditor suggests the elimination of duplication of effort by having the internal auditor prepare analyses of accounts or other data for his use, then appropriate carbon copies should be prepared for him. If special forms of analyses are desired then these should be laid out in cooperation so that, although serving different purposes, the working papers may be of maximum use to both.

Some independent auditors might be criticized for maintaining a haughty, indifferent and superior attitude; fortunately such individuals are in the minority. Such attitudes are entirely unjustified and personal, they are not representative of the certified public accounting profession, but reflect only the shortcomings of the individual auditor.

A lack of understanding between the internal and independent auditor may arise because the internal auditor does not appreciate that the independent auditor has certain "musts" in his program, as mentioned before. The internal auditor's attitude may be such that he resents the independent verification of something which he knows is correct. On occasion the independent auditor will refuse to rely upon the internal control effected by the internal auditor where he learns that the internal auditor's time has been utilized to a great extent by the accounting department in special studies, systems work, preparation of statements, etc. Sidetracking of the internal auditor to other than his principal function is often likely to occur. This is especially so because the internal auditor is usually a highly skilled accounting technician who can help out in special accounting problems. In smaller concerns with less well organized internal auditing depart-

ments, the internal auditor might find that he spends so much time doing special jobs for the Treasurer that he has little time for internal auditing.

Conclusion

Let us not lose sight of the goal in any auditing procedure, the completion of the review and the appropriate presentation of findings in a manner that is economical, expeditious, accurate, and complete. We, as independent accountants, cannot do less than certain required minimum of independent audit, but we must recognize internal controls where effective and adjust our

programs accordingly. The exercise of mature judgment is required in determining the extent of examination and whether the interests of stockholders and creditors justify the time and expense involved in pursuing any particular line of independent inquiry.

Because fullest cooperation is not always existent, it behooves both internal and independent auditors to subject themselves to self-analysis and criticism and to mend their ways if they find shortcomings. Auditors are professionally concerned with the criticism of others, yet, being human, they will have difficulty in making unbiased criticisms of themselves.



AN ADIRONDACK VIEW

Debit, Credit and Balance. Back in the twenties we studied accounting systems in a course by that name in the Springfield division of Northeastern University. And we really had to study in order to make the grade—because “we” were the teacher.

The pupils were all employed by day, mostly in offices. The teaching system was that the left side of the class answered the questions of the right side. All the teacher did was add to the supply of questions, oversee the resulting battles, and keep the trains of thought on the track.

For the question “What should be included in any accounting form?” the answer was, “The information that is habitually needed.” Then came the question “What information is most often used from an account in any general ledger?” The answer was “The balance.”

After twenty odd years, along came Thanksgiving, 1949, and with it came a niece who brought along an illustrative bookkeeping problem from her class in a top-level secretarial school—in the New York City area, no less! Shades of St. Peter! The ledger account had debits in the left half, credits in the right half, and no column for the balance—the pre-1890 model, which could be well named the “try-to-find-the-balance” model.

And so we wonder if the educational end of the accounting profession isn't too slow in going forward. Look, thou, unto the automobile, it changes every year; and the 1949 model knoweth not the 1920 model—except for four wheels! And the accountants, are they not still in the last century with the little fellows? Only this morning a phone call tells about a single entry system bringing trouble from the income tax boys. Are we driving 1949 Cadillacs and letting schools and clients ride with 1915 Stevens Duryea systems and methods? Shame on us!

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