Types of Internal Auditing—Past, Present and Future

By Earle H. Cunningham, C.P.A.

Introduction

The progress of internal auditing during the past few years has been so rapid that its present status is somewhat "spotty." Its utilization by management, the qualifications of practioners, and the level of execution are by no means of a uniform pattern. The general advancement made has not been entirely "across the board." There are a few companies who still are operating their internal auditing departments on the standards of a generation ago. Then there is the large majority who have kept their internal auditing departments on a par with current concepts. Another small segment has developed its utilization of internal auditing to a standard that might be considered somewhat in advance of the generally accepted standards of the present era.

Giving consideration to these facts, I feel that a brief review of the development of internal auditing should prove beneficial to all of us.

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Evolution of Internal Auditing

Internal auditing of the "Past" was an entirely different type of activity from internal auditing as we know it today. In fact, measured by current concepts, I doubt if we would recognize it as internal auditing. It was more in the nature of a clerical or policing function and did not require much more ability than a superior skill in mathematics, and a keen suspicious nature such as might be possessed by a "Conan Doyle" character.

Auditing is largely a matter of concepts; and concepts change with time. Considering auditing in the light of present day concepts, we can trace it back only a few years, but giving the term a very liberal definition we can trace it back to the Middle Ages. However, reference to auditing in those early periods was generally in respect to government accounting and fiduciary affairs.

They say, "Necessity is the mother of invention." It appears that internal auditing as developed by business is the result of a necessity. In the early period of business development, most enterprises were comparatively small units, and were closely managed and supervised by the owners. The proprietors or their representatives lived very close to the "firing line" and participated in the majority of the day-to-day transactions; they were able personally to exercise most of the controls necessary to insure effective operation. Nevertheless, the accounting and record keeping was largely a hand operation, performed by employees 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 of 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. It was "necessities" of this nature that were responsible for its birth.

Understanding the character of internal auditing as practiced in this early period, we can better appreciate the simple definitions appearing in our older reference books, and why emphasis was placed on the detection and prevention of errors and fraud.

The character of the work required, the way it was performed, the type of person employed, and the philosophies of the time, were no doubt responsible for Elbert Hubbard's definition of an Internal Auditor. While the type of auditor depicted by Mr. Hubbard is not a common species today, we still have a sufficient number, in modified form, to keep his definition in current circulation.

As I have indicated, internal auditing in its early history was largely a clerical routine with narrow objectives, and was principally a policing activity. In a way this was about all that was required, since the complexities of management and administration were comparatively few. With the introduction and development of the corporate system, business enterprises grew in size and complexities to the point where "owner" administration was impossible or ineffective. 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 employees. These developments caused radical changes in audit requirements and a demand for a higher standard of practice on the part of the auditor.

While internal auditing has enjoyed a steady advancement during the last twenty-five or thirty years, I feel that the progress made since the organization of The Institute of Internal Auditors has been greater than in any previous period of its history.

The Institute, working through its conferences, its publications and the individual Chapters, has developed a degree of internal auditing consciousness that never before existed. The scope of usefulness has been substantially broadened, the standard of practice considerably elevated, and principles and procedures have been *crystalized* in common understanding. Further progress is being made through the instrumentality of the Research and the Educational Committees; and while we have just cause for feeling pleased with our accomplishments, we still have much to do in consolidating and refining the gains made, and completing the projects in process.

One of the outstanding accomplishments of The Institute has been the formulation of an official and authoritative definition of Internal Auditing, and a defining of the responsibilities of the Internal Auditor.

Prior to the publication of Brink's book on internal auditing in 1941, we had no comprehensive and authoritative reference book on this subject. The definitions appearing in most of the accounting and auditing literature were not clear-cut and positive in character: they were so general or limited that they did not truly define internal auditing; and they frequently treated internal audit as a part of or a complement to the system of internal check.

The Institute's formal Statement—

(a) defining internal auditing,

(b) stating its objectives, and

(c) clarifying the internal auditor's responsibilities —

has provided a sort of Magna Charta for the Internal Auditor. It is the first time in the history of our profession that we have had an authoritative document that we could point to when someone asked us for a definition of internal auditing, inquired concerning its objectives, or sought information in respect to the auditor's responsibilities.

It creates a yardstick for the Internal Auditor to use in regulating and measuring his own standard of practice; it puts management on notice as to the quality of service it should receive; and it provides educational institutions with the fundamental information necessary to the formulation of appropriate courses for training the internal auditor. It summarizes clearly and comprehensively the functions of internal auditing when organized as a tool of management; a concept that is receiving increasing recognition.

Tools of Management

Today, the administrative problems of business are so numerous and complex that top management can no longer personally control, direct and supervise the multiplicity of activities common to the modern enterprise. Responsibilities have to be delegated and redelegated to a far greater extent than heretofore has been necessary. As a consequence, management has been forced to establish a system of controls to insure a proper administration of functions delegated, the accurate accumulation of management information, the adherence to prescribed policies and procedures, the compliance with government regulations, the conservation of values, and the faithful performance of many other analogous services incidental or necessary to the effective and successful operation of the company.

The number of individual controls making up such a system will vary, naturally, with the type and 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 most of them interlock with the general pattern of operations to such an extent that they become essential factors to the process of doing business.

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. While it is part and parcel of the system of internal control, it is not in any sense a part of the system of internal check.

In addition to functioning as a type of control for measuring and evaluating the effectiveness of other controls, internal auditing acts as a service agency for keeping management posted on the state of business by bringing to management's attention all material facts necessary to the successful conduct of the business, that might not otherwise receive consideration.

As pointed out in The Institute's formal statement on "The Responsibilities of the Internal Auditor," 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—

1. Company policies
2. Accounting procedures
3. Systems of internal check
4. Care and storage of records
5. Care and storage of company values
6. Operating activities
7. Many other analogous functions

While some managements have been slow in recognizing the full utility of internal auditing and its value as a tool of management, most of the larger progressive companies are placing increasing emphasis on those objectives which are essentially constructive.

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 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 this 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 top 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 a 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 this type would be—

1. Disbursement auditor
2. Pay roll 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.

To Whom Should the Internal Auditor Report?

They say it is a good policy to "let sleeping dogs lie." While I should perhaps heed the wisdom of this old aphorism, I hope you will bear with me while I "drag an ancient skeleton out of the closet"; one that has probably caused more controversy among the members of The Institute than any other subject. I want to remark briefly upon that threadbare, age-old question — "To whom should the auditor report?"

As some of you may vividly recall, there are certain groups who firmly insist that the internal auditor should report to the directors of a corporation or the owners of a business. Then there are others who are equally adamant in their convictions that the internal auditor should report to the President, Executive Vice-President, or the Executive or Administrative Committee. The third faction of the eternal triangle can see no serious objection to having the Internal Auditor report to the Controller, Treasurer or other staff officer of relative rank.

I do not propose to disagree with any of these professional brethren; I agree with all of them.

If the internal auditing department is organized at the proprietorship level, then the auditor should report to the Board of Directors, the Stockholders of a corporation, the partners of a partnership or the proprietor of a sole ownership business.

If the internal auditing department is organized at the management level, then the auditor should report to the President, Executive Vice-President or the governing committee of management.

If the auditing department is organized at the staff level, then the auditor should report to the staff head, be he a Controller, Treasurer, or other officer of relative rank.

Regardless of what we as individuals, or as an organized group, may feel is the proper level of organization for an internal auditing department, we must face the fact that we do have four levels, and so long as management exercises its prerogative to select the level that seems to suit its purpose best, we must accept such determination and work in accord with the level of organization with which we are associated.

Regardless of the level at which the auditing function may be organized, independence of the auditor is essential to effective operation. He must not only have complete independence of all personnel below the rank of his reporting authority, but he must have the full confidence and support of his principal; and his reports must be accorded serious consideration and effective follow-up.

I feel it is very important for us to understand and recognize the four levels at which internal auditing may be organized. By doing so we can better understand our many little differences of opinion, and thus be able to come to a more common understanding.

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. Periodic 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 Pay Roll 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, pay rolls, 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, semi-annually, yearly, or at irregular intervals.

Periodic 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 tailor-made 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.

Future of Internal Auditing

Contemporary writings, conferences, and our daily experiences give us a graphic picture of what current internal auditing comprehends. History provides us with a fairly clear conception of what internal auditing has been in the past. But speculation, prophecy, and trends of the times are the only agencies that we have for determining the future of internal auditing.

Reflecting on the progress of comparable professions, I feel we have every reason for being optimistic. In studying the development of business, we find that in early history, the head of the accounting department was the Chief Accountant. He matured into a Controller, and today the Controller is generally a member of the management family.

The clerical work of costing developed to the status of a department headed by a cost accountant; and now we have the Cost Executive, who in many cases is a member of the management group. The Director of Taxes, General Counsel, and many others who formerly were outside of the management cabinet, are now actively a part of top management.

Whether or not the Internal Auditor develops executive stature is a matter that rests entirely in his own hands. If he will broaden his knowledge of business, shed his clerical mantle, assume a management perspective, and render a genuine, constructive service to his company, he will gradually move to management status. While protective services will always be a basic function of the internal auditor, the future is going to emphasize more and more the importance of internal auditing as a tool of management; and as such it must be qualified to render constructive services of a high standard.