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Internal Auditing — A Constructive Management Control Function

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At the outset, I should like to dispose of an obstacle invariably raised in discussing management-control problems with a specialized group such as bankers, insurance officials, retailers, wholesalers, contractors—and perhaps even college and university business officers. Every group instinctively feels that its particular area of endeavor is different. Admittedly, there are important differences in the nature of operations and objectives among the various fields of endeavor comprising our economy. The academic atmosphere, idiosyncrasies of academic personnel, and the complexity of problems with which university business administrators must deal are different from those of profit-motivated organizations. Nevertheless, the techniques of administration and tools of management control applied successfully by progressive, profit-motivated organizations have been applied with equal success to the organization and management-control problems of colleges and universities.

The philosophy has been well received in my limited dealings with presidents and chief financial officers of universities. I might also add that this philosophy has been enthusiastically endorsed by the trustees of these institutions.

Today's Challenge to Business Administrators

Colleges and universities are playing an ever increasing and important part in our over-all economy and way of life. Educational institutions have always been important, but in this fascinating era of electronics, nuclear science, rockets and the like, institutions of higher learning are playing one of the major roles and, indeed, are our most treasured national resource. Furthermore, colleges and universities are big business, consuming an ever increasing proportion of our total national income, and are important factors in the economics of the communities in which they are located. Here in New Orleans, Tulane spends approximately $19 million annually. How many other enterprises are there of this magnitude in New Orleans? In my community, the University of Miami spends
approximately $18 million and is one of the major enterprises in Dade County. This same situation exists in other areas represented here today.

In preparing for this talk, my research also brought into focus a few of the many problems colleges and universities face today. For example, in 1900 only 4 per cent of our young people went to college. It is anticipated that by 1970, 44 per cent of the young people will be attending college. Furthermore, whereas in 1959 approximately 3,600,000 students attended college, this had increased to 4,200,000 in the Fall of 1962. By 1970, it is anticipated that this figure will increase to about 6,600,000.

In addition to the traditional role of preparing our citizens to face the problems of life, our colleges and universities are also being called on to provide organized research—a major undertaking, as you are aware, I'm sure. But note this impressive fact: That whereas in 1953-54, funds expended for research amounted to about $483 million, in 1958-59 such funds amounted to $831 million. These amounts are increasing every year. Here in New Orleans, Tulane's income from research amounted to over $5 million for the fiscal year 1961-62—or about 90 per cent of the amount received from student fees. Although these developments impressed me, I was startled to read in the 1961 Annual Report of Stanford University that income from government-sponsored projects was $19 million—or almost twice that of tuition income.

These figures may be interpreted to mean that those responsible for administering the business aspects of this priceless national resource face a real challenge to ensure that the management-control tools in their institutions are as efficient as possible. Furthermore, there should be no question but that internal auditing is an important, essential control function in the organization of every college and university. My remarks are intended to be thought-provoking in this regard.

INTERNAL AUDITING VS. INTERNAL CONTROL

Let us turn now to clarifying exactly what we have in mind when using the term internal auditing, and at the same time let us clarify the term internal control. Although related, the two terms are not the same.

The Institute of Internal Auditors may be assumed to be an authoritative source for defining terms related to internal auditing.
I quote from one of its publications entitled "Statement of the Responsibilities of the Internal Auditor":

Internal Auditing is the independent, appraisal activity within an organization for the review of the accounting, financial and other operations as a basis for protective and constructive service to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of controls. It deals primarily with accounting and financial matters, but it may also properly deal with matters of an operating nature.

The same publication clarifies the objectives of internal auditing activities as follows:

The overall objective of internal auditing is to assist management in achieving the most efficient administration of the operations of the organization. This total objective has two major phases as follows:

1. The protection of the interests of the organization including the pointing out of the existing deficiencies to provide a basis for appropriate corrective action.
2. The furtherance of the interests of the organization including the recommendation of changes for the improvement of the various phases of the operations.

These basic concepts of internal auditing provide the framework for discussing my thoughts on the subject.

I should also like to establish a common definition of Internal Control. For this purpose, I shall refer to the pamphlet Internal Control, published by the American Institute of Certified Public Accountants:

Internal Control comprises the plan of organization and all of the coördinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

Any of you who have not studied this publication, which was published in 1949 as a special report, should do so. My first reaction to this publication when I studied it in 1949 I recall quite vividly. One of my areas of responsibility in private industry, where I then was, was internal controls. This publication, and the broad scope it gave to internal control, provided the authoritative document for expanding my area of activity beyond accounting records and proved to be what I consider to have been a very effective step by the
management in improving the administration of the company. I suspect also that the development of management advisory services by the public accounting profession was stimulated immeasurably by the issuance of this publication on Internal Control.

**STATUS OF THE INTERNAL AUDITOR**

The perennial question "To whom should the internal auditor report?" can be disposed of with dispatch. In view, the realistic, practical solution is to have the person responsible for the internal auditing function report to the highest financial executive in the University. Theoretically, one might argue that the internal auditor should report to the board of trustees or perhaps to the president—but this is not realistic.

The Institute of Internal Auditors has some views in this regard:

1. The head of the internal auditing department should be made responsible to an officer of sufficient rank in the organization as will assure adequate consideration and action on the findings or recommendations. The organizational status of the internal auditor and the support accorded to him by management are major determinants of the range and value of the services which management will obtain from the internal auditing function.

2. Internal auditing should not include responsibilities for procedures which are essentially a part of the regular operations of a complete adequate accounting system or of a properly organized operating department. In some instances management may assign current operating responsibilities to the internal auditing department, but in such cases the execution of the current operating responsibilities should be performed by separate personnel and be subjected to the same review and appraisal as is accorded other operations.

I concur wholeheartedly and should like to dwell further on the point "keeping the internal auditor free of current operating responsibilities." There are too many situations where someone has been given a title of Internal Auditor, but the work performed becomes more a part of the routine procedure than an independent appraisal. Merely assigning a title does not of itself accomplish the effective implementation of the function. All of you should make sure that the internal auditing function in your respective organizations meets
the concepts outlined above, and that it does not become diluted by becoming a part of the routine procedures.

TECHNIQUES AND PROCEDURES—PROTECTIVE ASPECTS

As previously pointed out, internal auditing can be divided generally into the protective aspects and the constructive aspects.

I should like to dispose of the protective aspects by stating that the procedures followed should be comparable to the auditing procedures followed by independent public accountants—except that they would usually be more extensive. The areas covered, for example, might include: reconciliation of bank accounts on a selected test basis; petty cash counts of all funds maintained throughout the institution; circularization of accounts receivable on a periodic basis; review and test counts of inventories in all areas of the university; audit of investment accounts including an appraisal of the value of securities and investments; review of plant and fixed assets; review of deposit accounts; audit of current restricted trust funds; review of auxiliary enterprises such as cafeterias, student union, and housing; review of the operations of physical plant; review of the athletic department and ticket office; review of income from student fees and other fees; review of income from government grants and research contracts; and the like. This list represents some of the areas that should be covered in an internal audit program of a college or university. The protective aspects of internal auditing are necessary in all types of enterprises to minimize fraud, detect error or mismanagement, make sure that prescribed procedures are being followed, test for accuracy, and in general, to appraise the over-all results of the work being performed.

In conducting these reviews, the internal auditor should be encouraged to exercise his own judgment regarding the approach and the depth of the review. Superficial reviews that merely scratch the surface are worthless. In my own experience many instances of employee dishonesty were uncovered that would not have been uncovered unless the review had been made in depth.

For example, I recall auditing a branch-plant storeroom and purchasing function that had been selected for intensive study. One of the steps performed was to select approximately fifty vendors representing the largest volume suppliers and trace the vendor’s name and telephone number to the classified section of the telephone directory. Two of the vendors were not listed in the book. In
tracking down this situation, it was discovered that the invoices were from dummy enterprises controlled by the head of the storeroom who was also responsible for the purchasing function. His procedure was to place orders for certain types of articles directly with the suppliers and in turn rebill the company at an inflated amount. This, I might add, is only one of about seven such instances I have uncovered in my own experience.

Someone has estimated that the price tag on fraud amounts to a billion dollars annually and that fraud is taking place in all types of enterprises. I have heard of several cases in educational institutions. This should be sufficient evidence that the protective aspects of internal auditing are, indeed, important.

TECHNIQUES AND PROCEDURES—CONSTRUCTIVE ASPECTS

However, the constructive aspects of internal auditing, in my view, provide the major opportunities for contributing to a more effective organization. The Institute of Internal Auditors describes this as the second major phase of internal auditing:

The furtherance of the interests of the organization including the recommendation of changes for the improvement of the various phases of the operations. The attainment of this objective involves such activities of the internal auditor as:

a) Reviewing and appraising the policies and plans of the organization in the light of the related data and other evidence.
b) Reviewing and appraising the internal records and procedures of the organization in terms of their adequacy and effectiveness.
c) Reviewing and appraising performance under the policies, plans and procedures.

This is the area where the internal auditor can be of great assistance to the executives responsible for the business affairs and control procedures of your universities. Although today we can only skim the surface, I should like to suggest some potential areas for improvement which in my own experience have been fruitful in working with various types of enterprises. These suggestions will be presented in the form of questions. They are grouped according to organization, policies, cost controls, purchasing, personnel procedures, systems and procedures, and data processing.
Organization

• Has the organization of the university been set up according to a definite plan, or has it developed with little or no recognition of basic functions or logical groupings of activities? Has consideration been given to the changes in the scope of the university's operations, such as the increase in research contracts? Has an organization survey been made recently to determine if any changes were in order in light of the changes in the scope of the university's operation?

Does every individual in the administrative area know to whom he reports and who reports to him? Have functions and responsibilities been clearly defined for each department of the university—particularly in the non-academic area?

The whole area of organization is one that the internal auditor is in good position to explore and report upon.

Policies

• Is there a policy manual?

• In examining the activities of the various segments of the university operations, are the policies of the university being adhered to?

It is, of course, difficult—in fact impossible—for the internal auditor to review the adherence to the university's policies if the policies have not been documented. Where a policy manual does not exist, the internal auditor could very well recommend that existing policies be studied and formalized in some manner.

Cost Controls

It is basic that educational institutions should operate according to a carefully prepared budget. Indeed, the foundation of the accounting system and reporting system is the budget. All of you annually go through the exercise of making sure that the estimated expenditures for the year are in balance with the estimated available income. However, there is a big difference between establishing the budget at the beginning of the year and taking proper action during the year when the actual results are not in accord with the budget or basic plan of operation. I am suggesting that the budgeting and related reporting systems afford opportunities for improvement. The internal auditor has opportunities to ask questions in this area:
• Is there provision for frequent comparison of budgeted expenses and income with actual performance? What reports are made of significant differences and what actions are taken?
• Are budgets set up and classified to coincide with the organization chart and areas of responsibility?
• Are department heads required to explain the differences between budgeted amounts and actual expenditures?
• Are regular reports that provide significant control information distributed to department heads? Are they presented in such a manner as to highlight areas requiring action and in time for effective action to be taken?

Purchasing

• Is the responsibility for purchasing all of the university’s requirements concentrated in a purchasing department or is this left to the department heads to use the services of the purchasing department at their option? This is one area that the internal auditor should explore to make sure that to the greatest degree practicable all purchases are placed through the university’s purchasing function.
• Is the selection of the vendors left entirely to the discretion of the purchasing department? Are all contracts with suppliers made by the purchasing department or do most suppliers deal directly with the department heads and use the services of the purchasing function merely to take care of the paper work relating to the transactions?

Personnel Procedures—Non-Academic

I do not feel qualified to comment on the area of academic personnel and the policies and procedures related to this group, but it seems to me that non-academic personnel in an educational institution are no different from personnel in private industry. Accordingly, the following questions are directed to the problems related to non-academic personnel:
• Has the responsibility for the administration of non-academic personnel been centralized and assigned to one responsible individual?
• Are the employment applications for all non-academic personnel cleared through one responsible executive?
• Are all new non-academic employees properly indoctrinated
and introduced to the university, their supervisors and co-workers? Are the university's policies, rules, and job details properly explained to all new employees?

- Are personnel policies relating to holidays, time off, overtime compensation, etc., uniform throughout the organization?
- Are salary adjustments reviewed and handled in such a manner that all non-academic personnel are given the same consideration? Are all employees performing similar type work throughout the university paid according to the same compensation scale?
- Is anyone responsible for making sure that each employee has a regularly scheduled discussion with his supervisor (at least once a year) regarding his performance, status, etc.? Is this made a matter of record in the employee's personnel jacket?

**Systems and Procedures**

- Are written standard practice instructions in use and are they up to date?

Ideally, there should be a systems and procedures function assigned to the business manager's area of responsibility which should provide for continuous review of equipment, facilities, and office methods throughout non-academic areas to make sure they are as efficient as practicable. If there is no separate systems and procedures function, this function then becomes an important phase of internal auditing.

**Data Processing**

More and more universities and colleges today are installing sophisticated data processing methods, including punch card accounting equipment as well as electronic computers. Indeed, colleges and universities as a group comprise one of the biggest users of punch card equipment and electronic computers. Unfortunately, throughout all enterprises there are many installations of data processing equipment that were installed on the basis of intuitive judgment rather than on factual survey. Accordingly, I feel very strongly that the operations of the data processing function should be reviewed periodically from an objective point of view. The internal auditor is in a logical position to make such a review. In doing this, he should keep in mind that the prime objective of the data processing function should be to develop the end-product reports and other information
that would be effective in helping the other areas of the university operate more efficiently. The following questions should be helpful in appraising the data processing function:

- Obtain a schedule of all end-product reports produced by the data processing department and determine why these reports are created. Who is going to use the data; for what purpose is it to be used; how much of the data does the recipient use; when does he need the information?

- Does the manager of data processing maintain a list of all of the reports and other end products he is expected to produce, together with scheduled times for submitting these reports to the recipients?

- Does he know the relationship of his department to other departments with regard to the over-all procedures in the university? Does he have a definite schedule of the availability of source documents from other departments?

- Is a general manual of procedures maintained for the department that includes a schedule of reports, exhibit of reports and source documents, and general application flow charts?

- Are production records maintained of each key-punch and verifying operator to show speed and column per hour and accuracy as reflected by percentage of errors?

- Are there definite “due in” and “due out” times for each job?

- Have priorities been established for the various jobs to be done?

- In general, does the data processing manager have adequate control over his operations?

It is surprising how few machine-room operators have the answers to these questions or even think about their operations in this manner. The internal auditor can render a valuable service by determining with the data processing manager the answers to these questions.

RELATIONSHIP OF INTERNAL AUDITING TO THE INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT

As a representative of the public accounting profession I would be remiss if I did not at least touch on the relationships between internal auditing and the CPA. Generally speaking, the objectives of the internal and external auditing functions relate to the verification of records and are concerned with improving efficiency and facilitating
controls. The techniques used are similar. The basic difference is that the external auditor is making an independent verification or performing an attest function relied upon not only by the management and the trustees of the university but by the general public as well. However, the work of the internal auditor should be coördinated with the work of the external auditor. Where there is coördination, coöperation and proper planning, the net result is more effective utilization of time and skills by both the internal and the external auditing staffs, and a better job is done for the management of the university.