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Discussant’s Response to “Internal Control: Progress and Perils”

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Introduction

This comment is organized around the Winters and Guy paper and the COSO (Committee of Sponsoring Organizations) Internal Control-Integrated Framework project [COSO, 1992; Winters and Guy, 1992]. I was a member of the Project Advisory Council to COSO, Guidance and Oversight. This group included representatives from each of the COSO participating organizations, FEI (Financial Executive Institute), IIA (Institute of Internal Auditors), IMA (Institute of Management Accountants), AICPA (American Institute of Certified Public Accountants), and AAA (American Accounting Association). As the AAA representative, I participated in all COSO Advisory Council deliberations. As is the habit of the AAA, I was not authorized to speak for the Association. The AAA Executive Committee recently endorsed the private sector initiative represented by the internal control framework project, but did not endorse the specific contents of the report. Discussions with the AAA were still in progress when this paper was submitted. Any comments made by me concerning the results of the framework study are mine and not those of the AAA or other COSO Advisory Council members.

Background

Some background, as I interpret it, on the evolution of the COSO Internal Control project may be of use. In developing the COSO response to the Treadway recommendations concerning an integrated definition of internal control, it was decided to develop the project within the existing FERF (Financial Executive Research Foundation) research framework. The usual research process involves a task force, such as the COSO Project Advisory Council, but drawn from FEI members. Ordinarily a FERF project team is in direct charge of their project and accepts direction from the task force as it deems reasonable. It is the project team’s option to reject advice and FERF’s option to publish or not publish the resulting report. Given the nature of this project and the perception by many that the internal control project was essential to providing a basis for potential legislation and/or regulation in the area, the COSO Advisory Council wanted to take a much more direct hand in setting direction for the resulting report. The initial relations between the Coopers & Lybrand project team and

* The author wants to thank the members of the COSO Advisory Council for their valuable input on an earlier version of this paper. Interpretations remain my own.
the COSO Advisory Council required some effort due to these circumstances. The Coopers & Lybrand team, quite reasonably, considered all COSO Advisory Council input as just that — advisory. They chose to accept some, but certainly not all, of the advice. The COSO Advisory Council found this difficult to deal with; however, an amicable set of protocols was developed over time.

**Changed Project Management**

During this period, I believed that both the Coopers & Lybrand project team and the COSO Advisory Council anticipated that the final product would be a FERF monograph. However, approximately halfway through the effort it was concluded that a more extensive public disclosure effort than originally planned would enhance the possibility of general acceptance of the project results. Because of the advocacy implications, FERF withdrew from the management of the project. As a result, no monograph would be published by FERF. Discussions following this decision focused on the means of developing the COSO project in a form more like that of a standard setting effort. The resulting public exposure process can be characterized as a standard setting effort; however, as COSO has no standard setting authority, whether the results will constitute a standard will depend solely upon the degree of acceptance this document generates.

**The COSO Framework Study**

The COSO Framework is premised on the idea that internal control is essential to the efficient and effective operations of a business, reliable external financial reporting (note that COSO only went this far on the topic of external reporting) and compliance with laws and regulations. It is also influenced by a belief that legislators and regulators have misconceptions about the value of internal controls or, at least, about the value of external reporting on internal controls. The concern with legislators and regulators explains some of the positions adopted by COSO.

Serious questions arise as to the importance of internal controls and reporting on internal controls. First, is internal control necessary to meet the operations, reporting and compliance objectives of a firm? If we can rely on even the simplest biological analogies to the marketplace, survival of the fittest, we can pretty well accept that internal control is important to the management of a firm. As a corollary, we can assume that some form of internal reporting will take place on this topic. Virtually all successful firms commit some fraction of their resources to development, maintenance, and reporting on internal control systems. A virtually unqualified “yes” seems to be appropriate with respect to this point. How much firms commit is, at this time, based on a firm by firm cost/benefit analysis, taking into consideration current mandated regulations. Less obvious is the answer to the second question: Is external reporting on internal control useful? There is little empirical evidence to support the demand for external reports on internal controls other than from legislative and regulatory bodies. Winters and Guy [1992, p. 183] contend that “Those who advocate reports on internal control usually cite two major benefits...a behavioral effect...[and an] information content [benefit].”

The COSO Framework is composed of four separate volumes: Executive Summary; Framework Study; Management Reporting to External Parties; and Tools. This structure seems quite obvious with the possible exception of the
separation of the Management Reporting to External Parties from the Framework Study. The separation is the result of COSO advisory members’ deliberations on the topic of external reporting and significant contradictory commentary on the same topic from those receiving the exposure draft. The contradictory commentary, disagreements and concerns are, in my opinion, reflected in the final document in a number of ways: external reporting is not required for good internal control; only external financial reporting is addressed in any substantive and explicit way by the report; and external auditing is not given much explicit prominence in any of the volumes. This latter point may reflect management’s concern for expanding audit fees and a general feeling that the audit adds little value in the circumstances addressed by the report. The public accounting participants in the process would undoubtedly not accept the lack of value added position; however, concern for extended legal exposure, a desire to make progress on a common set of definitions and criteria and the inclusion of a volume specifically addressing external reporting issues may influence them to accept the report.

Summary of the COSO Documents

The following comments are based on the COSO report, *Internal Control-Integrated Framework*, Committee of Sponsoring Organizations of the Treadway Commission, Revised Draft, February 1992, revised based on recommendations of the April 13, 1992 COSO Advisory Committee meeting [COSO, 1992]. Subsequent changes are reflected where they are known to be part of the planned revisions.

Throughout this paper I have drawn very heavily (in fact, as much as possible) on the actual words used in the COSO documents. I have not used quotation marks or page references, as they would be distracting. However, subject to my errors in transcription or subsequent COSO changes, statements attributed to COSO use COSO’s words. As you will have noted above, I have also drawn from SAS 55 and the Winters and Guy paper [AICPA, 1988; COSO, 1992; Winters and Guy, 1992]. In these cases, I have endeavored to use page and paragraph references as well as quotation marks. These quotations and observations are inserted at the points where they seem to bear on the COSO volumes discussed. I have endeavored to clearly distinguish my opinions, which are mine alone.

a. **Objectives of Framework Study:** COSO established two objectives for its integrated framework study, (emphasis added) to:
   - Establish a common *definition* serving the needs of different parties.
   - Provide a *standard* against which business and other entities—large or small, in the public or private sector, for profit or not—can assess their control systems and determine to improve them.

b. **Success in meeting these objectives requires:**
   - A common and generally accepted *definition* of internal control.
   - A generally accepted set of *standards for assessing whether an organization’s internal control system meets effectiveness standards*.

The COSO document does present a definition and standards, but it is too early to know whether either will be accepted as the common definition and standards for internal control. There was certainly a good deal of discussion about the definition and standards among all parties to the process. Many of the
exposure draft comments have been incorporated into the definition and standards. These comments were incorporated, both to improve the definition and standards and also in an attempt to assure the general acceptance necessary to meet the COSO study objectives. Without additional exposure efforts, one could expect continuing dissatisfaction with specific aspects of the definition. Some of these disagreements would clearly be a matter of editorial choices, e.g., where the wording is not that used by a particular organization in its current literature. These disagreements are unlikely to persist if the COSO framework gains any significant degree of prominence. Other matters may prove more substantive but will have to await attempts to apply the COSO framework in the field to existing and newly arising problems, e.g., external compliance reporting in the banking industry. Disagreements about the breadth or narrowness of the definition and standards (both exist) are unlikely to be resolved at this late date. The broader definition adopted by COSO had the predominant level of support from both COSO participants and those responding to the report drafts.

It is too early to know whether the COSO framework will become the standard of application. However, there are forces that encourage its adoption. The Congress and its regulatory arms may find it a useful point of departure when considering new legislation or regulation in the internal control reporting arena. There are already indications that at least part of the COSO document will be included in pending regulations. The private sector participants clearly hope for such reliance and for an understanding on the part of the lawmakers that the COSO framework also addresses the limits of lawmaker requests. Some private sector participants hope that it will act as a brake on regulators’ desires for additional mandated public reporting and auditing. At the same time, the public accounting sector may find that the COSO framework provides them with a ready marketing tool. However, while there are incentive compatible reasons to expect acceptance by many of the principals involved, this acceptance is only likely to be retained among the participants based on early successes or failures in application. Winters and Guy say [p. 180]:

Agreement about what internal control is...may be attainable. For example, regulatory agencies...have indicated they will adopt the COSO report as the standard against which both the required management and auditor assessments of internal control effectiveness...should be judged...imbuing the COSO report with ‘general acceptance’....

More experience implementing the COSO report is needed...before its success can be evaluated....

Realistically, I believe that the COSO framework will become an integral part of the internal control literature for the next five to ten years. During that time events will determine its survival as a seminal work or as a useful effort needing elaboration, extension or revision. In any case, it will have set the agenda for consideration and action and moved the internal control discussion forward.

Definition

COSO defined internal control [COSO Advisory Committee meeting, February 1992; revised based on April 13, 1992] as follows (emphasis added):

Internal control is a process, effected by an entity’s board of directors,
management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of external financial reporting.
- Compliance with applicable laws and regulations.

According to SAS 55, Para 6:

An entity’s internal control structure consists of the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. (Note: The SAS focus of interest is on those parts of the internal control structure “...relevant to an audit of the entity’s financial statements.”)

The categories of internal control form the expanded basis of the COSO definition. The explicit incorporation of operations and compliance categories substantially expands the usual ASB (Auditing Standard Board) definition. While SAS 55 broadened the definition of internal control and eliminated the accounting and administrative controls distinction and as a result recognized the importance of operations, SAS 55 only addresses the context of reliable external financial reporting and the planning of an audit for that purpose. The COSO definition envisions these categories as important in their own right, perhaps even more important than the more limited outlook suggested by the ASB. COSO recognizes that there is no sharp line delineating these categories and that consideration of any category will likely involve consideration of aspects of another category. COSO also recognizes that the methods of measurement needed to address these categories are not equally well developed. They do not consider the measurement problem to be sufficient to suggest that the categories should be ignored or de-emphasized. Those concerned with the regulators’ apparently lesser concern for the limitation of measurement in these areas may continue to be concerned about the inclusion of these categories.

According to Winters and Guy [p. 180-181]:

... Such a categorization...creates a perception that internal control components within these categories are clearly identifiable and distinguishable and that experience and expertise in applying the COSO criteria [see Components below] is equally well-developed for each of these categories.

This perception is not valid and, although the COSO report attempts to dispel the inference, our experience with numerous regulatory requests for auditor services on internal control demonstrates that the misperception is common....

Regulatory initiatives calling for such implementation are fast outpacing our ability to provide those services....

While the broader definition had the preponderance of support, some of those commenting on the definition felt that it was too broad to the point of defining not internal control, but management. Others felt that it should be narrowed to encompass only financial statement preparation. There was a good deal of concern that the broad definition would extend the litigation exposure of anyone associated with the design, functioning or reporting on internal control,
and that it would encourage regulators to extend their reach in this area.

**Components**

Integral to the definition are five interrelated components. The drafters of the COSO framework indicate that these components are derived from the way management runs its business. The definitions below are drawn from the related chapters in the Framework document. I have, as noted earlier, used the document’s wording.

**Control Environment** - Control environment factors include: the integrity, ethical values and competence of the entity’s people; management’s philosophy and operating style; the way management assigns authority and responsibility and organizes and develops its people; and the attention and direction provided by the board of directors.

Winters and Guy point out [p. 181]:

Another concern about the COSO criteria is that certain components may be so subjective as to not be susceptible to reasonably consistent estimation or measurement. Those components most often cited include integrity, ethical values and management competence.

These are actually all a part of a single component, Control Environment. They also say, [p. 185]:

...[T]he expanded definition [of internal control in SAS 55] brought the control environment and the accounting system directly into the scope of the auditor’s consideration. ...[t]hese components are much more closely associated with the primary causes of financial statement misstatements than are control over individual transactions.

Given the above two statements by Winters and Guy, I am not sure why the first comment is offered as the concepts are already in SAS 55. Do Winters and Guy mean that SAS 55 already allows auditors to rely on overly subjective inputs to too great a degree? This point has been argued elsewhere by Morton and Felix [1991] and Kinney, et. al. [1990].

**Risk Assessment** - Risk assessment involves identification and analysis of relevant risks to achievement of the objectives as a basis for determining how risk should be managed.

Winters and Guy comment that [p. 184]:

...Even more modernistic and intriguing are questions about the meaning of control risk in an audit of internal control—that is, what does control risk mean and how should it be considered when an auditor is engaged to express an opinion on the effectiveness of internal control over financial reporting, compliance, or operations?

I am unclear as to the uniqueness of the problem as it applies to financial reporting as this concept seems quite well established, i.e., the probability of material error occurring and not being identified and corrected by the control system. With respect to operations and compliance, the problem relates to the materiality measurement concept discussed elsewhere and the definition of error. In both of these cases, Winters and Guy have a point.

**Control Activities** - Control activities are policies and procedures (which are the actions of people to implement the policies) to help ensure that management
directives identified as necessary to address risks are carried out. Control activities can be divided into three categories, based on the nature of the entity’s objectives to which they relate: operations; financial information reporting; or compliance.

**Information and Communication** - Pertinent information must be identified, captured and communicated to people in a form and timeframe that enables them to carry out their responsibilities. Information systems produce the reports containing operational, financial and compliance-related information that make it possible to run and control the business. They deal not only with internally generated data, but also with information about external events, activities, and conditions necessary to informed business decision making and external reporting.

**Monitoring** - Internal control systems need to be monitored — a process that assesses the quality of the system’s performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two.

The tests of controls discussion in Chapter 6, Monitoring, implies that the “actual functioning” of a system can be established by discussion with personnel. This is recognized to be a weak statement of the evidence required to establish “actual” functioning and likely to be a satisfactory approach in only rare circumstances. In my opinion, it allows too much evidential weight on discussion with personnel.

SAS 55, Para 51 states: “Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control procedure.” The use of the word “generally” is, in my opinion, a weak statement similar to that in the COSO report. Also, SAS 55, Para 8 says:

For purposes of an audit of financial statements, an entity’s internal control structure consists of the three following elements: The control environment; The accounting system; and Control procedures.

Note that, from above, it would appear that the SAS and COSO Control environments are pretty much the same. However, the SAS Accounting system and Control procedures appear to be included primarily in the COSO Control activities. Clearly, the SAS envisions Risk Assessment, Information and Communication and Monitoring as part of internal control. This is seen in SAS 55, Para 29: “Control risk should be assessed in terms of financial statement assertions.”

The original exposure draft of the framework included a larger number of components. Based on exposure draft responses, several new aspects of internal control were added to the components and the components were reduced in number. It would appear that COSO has incorporated virtually all of the exposure draft commentary in this area. Remaining debate seems to be focused more on presentation and integration within the model. Those who feel that the components should be incorporated directly into the definition in order to produce, in their view, a more complete stand alone definition will be disappointed.

All components apply to all categories and are, in that sense, an integral part of the definition of internal controls.

The Framework takes the position that all components must be present to have an effective internal control system in each of the category areas. It is rec-
ognized that some trade-off may exist as to the strength of one component versus another and still have an effective internal control system, but all components must be present. It is hard to imagine an entity that is devoid of some aspect of each of these components.

**Effectiveness**

Internal control can be judged effective in each of the three categories, respectively, if the board of directors and management have reasonable assurance that (emphasis added):

- They understand the extent to which the entity’s operations objectives are being achieved.
- Financial reports are being prepared reliably.
- Applicable laws and regulations are being complied with.

Commentary on this aspect of the study tended to concentrate on the meaning of reasonable assurance as it applied to the reliability and compliance categories. Those with a legal background tended to be concerned because of the meanings applied to these terms in the law. COSO decided to continue with these commonly used terms and to rely on explanatory materials to make their meanings, in this context, clear. Some expressed concern about the focus on boards and management assurance as opposed to third party assurances. As third party assurances come only with external reporting, COSO decided to address that issue only where third party reporting was discussed, i.e., external financial reporting.

As stated in SAS 55, Para 17:

Whether an internal control structure policy or procedure has been placed in operation is different from its operating effectiveness...This Statement does not require the auditor to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure.

Further in Para 29, SAS 55 states that:

Assessing control risk is the process of evaluating the effectiveness of an entity’s internal control structure policies and procedures in preventing or detecting material misstatements in the financial statements.

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Internal Control Model - Categories And Components

While not presented in the currently revised document, an internal control model is implicit in the above (the model was developed and presented to the COSO Advisory Committee by the drafters and may appear in a future draft of the report). I will present a slightly adapted model framework from that derived directly from the above and discuss its relationship to the current COSO Framework document.

Note that the internal control definition categories form the columns of the matrix and the five components the rows. In the current document the column labeled above as "External Reporting" is labeled "Reliability of financial reporting." I have used the more general, "External Reporting" because I believe that it provides a more internally consistent model and allows for all forms of external reporting. There may be a bit of confusion about my apparent switch to "external" reporting as a header in that the definition does not include the word "external" in the financial reporting category. Thus, the financial reporting category refers to all financial reporting, internal and external. However, other forms of internal and external reporting considered by COSO are a part of the information and communications component. Treating the financial reporting category as primarily a concern for external reports seems, to me, more appropriate and consistent for model purposes. It also seems appropriate to do so because of the external reporting emphasis given this category in the separate volume on the matter. The following discussion as it relates to financial reporting has an external reporting orientation.

Winters and Guy believe that “[I]nternal control theory and applications have progressed,...” [p. 177] It is not clear to me that we have made much progress to a normative theory of internal control beyond general control theory as appearing in the industrial engineering literature. We do have some conceptual models, such as the one above, that form the basis for developing criteria for internal control. These are descriptive theories of internal control derived largely from the observation of practice.

The rationale behind the three categories can be developed along several different lines of thought. When approaching it from the COSO Framework writers’ point of view, the three categories are considered in terms of an entity’s conditions for continued economic existence and success. The operations category represents the need to transform inputs into outputs in an economic manner that will satisfy the customer’s needs. The compliance category may be viewed as meeting the essential restrictions placed on an entity by various sanctioned governmental and voluntary external entities. Where inability to supply the customer market will result in failure through competitive market forces, lack of compliance with critical laws and regulations can result in entity failure even when some parts of the market are clamoring for the product. External reporting may be required under a variety of circumstances. The one most obviously envisioned by the current COSO document and present practice is external financial reporting. In a financial market environment like our own, obtaining the necessary capital to permit continuing operations requires communications with external capital providers. Others may also use external financial reports for purposes such as credit setting, contract negotiations, etc., and these are envisioned by COSO as well. The broader category I have used, “External Reporting,” also envisions external reporting not currently considered
commonplace, e.g., external reports to bank regulators, external reports of compliance with environmental laws and regulations, etc. The COSO Framework document considers that external reports other than external financial reports reside in either the operating or compliance categories of the definition through the component “Information and Communication.” They also believe that the inclusion of only the more limited external financial reporting category will better retain and highlight the link to the separate volume on external financial reporting. Thus while the COSO form of the model allows for other than financial external reports, it does so only indirectly.

The above comments address materials embodied in Chapter 1 of the COSO Framework document. The balance of the COSO statement is an elaboration on the above definition, components and effectiveness statement. Five additional chapters are devoted (one each) to the five components, a sixth chapter to limitations of internal controls and a final chapter to the roles and responsibilities of the various parties within an entity.

Management Reporting to External Parties

This section deals only with external financial reporting. The issues of external reporting on operations and compliance are not dealt with by the COSO Framework.

There is a major discontinuity between the process orientation of the Framework document and the state orientation adopted in this volume. The Framework’s definition of internal control as a process seems to be appropriate and creates no problem until we encounter reporting issues. In that context, two problems arise. First, there is the matter of the current level of technology and cost of auditing a process. This problem exists for both internal and external reports, but is probably most significant for external reports where an audit might be considered. Second, particularly in an external report, the degree of exposure when expressing an opinion on the continuing operation of a process is perceived to be more extensive than expressing an opinion on the point-in-time state of a system. There can be little argument that as no actions actually occur at a point-in-time, more exposure with respect to actions exists if one expresses an opinion covering a period of actual system operation. These issues become evident in the external reporting volume where point-in-time reporting is selected, i.e., a report on a state of the process but not the process itself.

The volume indicates that users may be most interested in whether the system was functioning and will function in the future. However, the volume also indicates that management and/or auditors cannot provide much evidence on either. With respect to the future, there can be no question that evidence is not obtainable; with respect to the past, the evidence is obtainable. However, in the context of this volume, even if obtained and indicative of a material weakness, it would be reported only if management had not corrected and tested the change.

Winters and Guy [pp. 186-188] argue that the behavioral and information content benefits of reporting on internal controls do not flow to external financial reporting because if a material error occurs, it can be corrected and the external financial reports will be reliable; this may miss the point or simply be a matter of definition. They are certainly correct that the final product of the successful audit will be reliable financial statements even if the internal control system did not produce them as desired. However, in the interim, the failure of
an internal control system to produce such statements may be costly in terms of 
decisions made with faulty information or losses incurred through resource dis-
sipation. Perhaps the poor decision and resource loss issues are really an opera-
tions issue. This is the position of the COSO Framework. Nevertheless, I do not 
agree with the statement by Winters and Guy [p. 188] that “... for the financial 
reporting category, the argument boils down to which type of information is 
least costly to provide.” Reports on internal control provide different informa-
tion about the firm than the output contained in the financial statements. It 
remains an empirical issue as to whether this different information is worth the 
cost of production. I see the internal control reporting on financial issues in 
pretty much the same light as that on operations and compliance. In all three 
areas internal reports are provided to management; in all three areas there is dif-
ferent information than would be provided by an output report only. In all three 
areas there are, internally, actions that can be taken to create a more effective 
and efficient environment; in all three areas, externally, there is very little 
empirical evidence as to the demand for reports on these matters. In all three 
areas, a conceptual argument can be made that the information would provide 
another means of evaluating management performance and thus in making deci-
sions on retention and rewards for management. I would agree with Winters and 
Guy [p. 189] that “In our view, not much progress has been made in resolving 
the questions concerning the relative merits of reports on internal control versus 
reports on output,” although I do not see it as a versus issue.

Unfortunately, whether by intent or not, and as noted by Winters and Guy, 
the COSO report reads like an attempt to avoid ever having to report a material 
weakness:

Another peril arises because the report uses the concept of a material 
weakness to separate effective from ineffective internal control. Using this 
measure causes two problems. First, no conceptual or empirical construct 
of a material weakness exists for either internal control over compliance or 
operations.... In the absence of sound definitions...such evaluations will be 
subject to extreme variations in consistency and usefulness.

Even though an accepted material weakness concept exists for internal 
control over financial reporting, it also poses complications. There are 
strong disincentives to concluding that such weaknesses exist [pp. 181]

...If the concept of material weaknesses, as prescribed in both the COSO 
report and the proposed attestation standard, results in the virtual absence 
of material weaknesses..., all reports will look alike. These boilerplate 
reports are not likely to have much information content and, instead, serve 
only as a basis for litigation.... [p. 190]

The position adopted on reporting material weaknesses is supported as a con-
structive focus designed to encourage monitoring and correction throughout the 
period. Admittedly, it does encourage correction and “testing” on a “timely” 
basis. However, it assumes very little value in the disclosures exercise, but pro-
vides no evidence to support that view. Winters and Guy assert that [p. 189]:

...We believe...that internal control reports are much more useful for 
these [specified] parties than for the general public, and less likely to cre-
ate perils for management and their auditors.
Reports to the general public are much more hazardous than those to specific users; hazardous to the public, the entity, and its auditors.... At most members of the investing public might alter their investment decisions....

The reasons given by them are the usual “it will confuse the public” statements.

The COSO document asserts that external reporting is not an element of internal control, but provides no evidence that such reports do not contribute to internal control. The document also asserts that point-in-time reporting is, in general, most appropriate, but offers no evidence. Further, the document specifically asserts that point-in-time reporting meets the needs of security holders and other external parties, but provides no evidence.

The discussion concerning interim reporting reduces, in my opinion, to reporting on system design for interim reporting, a point of view rejected when discussing the need to report on effectiveness. This is perhaps a bit too harsh a judgment, but it definitely reads as an attempt to avoid reporting any material weaknesses.

**Conclusions**

What can we expect the debate over internal controls to be like during the coming years? First, the debate over the definition of internal control is not over. Despite COSO’s valiant attempt, the lack of a theory of internal control beyond that found in engineering control theory assures that the debate will continue. COSO has provided one model with its categories and components of internal control. Like many other models, it does not derive from some fundamental postulates but rather from a studied consideration of what occurs in the business environment. This does not make these models useless. In fact, the very lack of a theory makes them particularly important for the improvement of practice as well as for their potential contribution to the eventual creation of a more fundamental theory.

Second, there are even more pragmatic reasons to expect the debate to continue. While the COSO report will gain acceptance as a point of departure when considering internal control issues, there will be debate over the details whenever there is a disagreement among participants as to the desirability of some action bearing on internal controls. For example, a regulator under pressure to accomplish some goal, such as the perceived protection of the general public, may come to believe that a report by management, attested to be the auditor’s, will serve to create that protection. Whether the regulator is correct or has more than political support for the position may be of less consequence than the need to take action.

This is already evident in the recent banking regulation requirements for reporting on compliance with laws and regulations. Adherents to the COSO report may arrive at differing positions on the desirability of this particular action. Those who desire to have such reports could take the position that COSO addressed the standards for such reports, even though they provided some cautions and no example reports. Others might believe that COSO was more than cautionary in its concern for the expansion of external reporting in this area and that, in fact, COSO would not support the extension of external reporting in this area. Whatever the “facts” in this particular case, it would appear that the regulations will stand and that the debate will move in the direc-
tion of limiting the laws and regulations to which the opinion will apply, specifying the detailed attestation work necessary and attempting to specify and limit the risk exposure to the auditor, i.e., in large part dealing with those details of measurement and risk not addressed by COSO in the area of external reporting on compliance with laws and regulations.

As there are already many other such reports being prepared for internal or limited use (for example, on environmental control matters), we might expect to see a series of proposals for additional public disclosures. We can all think of public interest groups that may find it worthwhile to push for such action.

The internal control debate is only one of many areas where the profession’s exposure has increased in recent years. There is little doubt that the profession has had a long standing role with respect to the evaluation of internal controls. However, since the enactment of the FCPA (Foreign Corrupt Practice Act), the nature of that role has been expanding. FCPA opened up avenues for increased service to clients in satisfying the requirements of that act. At the same time, meeting this client service clearly opened up the potential for auditor attestation exposure. For some time the profession resisted offering an external attestation opinion on internal controls. It now appears that the profession supports some form of external attestation report. The argument appears to be that the professionals are being held liable in any case, so let’s do the work and get paid for the risk. However, this is only one area of increased risk in the ever expanding client service domain of the profession.

As the profession has moved or been pushed, depending upon your perspective, from its traditional franchise as the auditors of external financial reports to client service organizations, its practitioners have found themselves caught in the muddy waters of marketing essentially new services while attempting to limit exposure. Unfortunately, one gets the impression that each service is opening up substantial, unanticipated exposures and that attempting to limit the exposure is akin to holding back the tides. I have no solution. Perhaps limited liability corporations and tort reform will help, but I am fearful that even with such reform the profession is in danger of losing its franchise or being charged so high a price for its franchise as to lose its business viability. Neither of these results is in our interests or the interests of the broader society.

References