Is the second standard of fieldwork necessary;

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Introduction

Today's generally accepted auditing standards were primarily framed in 1947 by the Committee on Auditing Procedure (Committee) of the American Institute of Accountants, the predecessor bodies of the current Auditing Standards Board and the American Institute of Certified Public Accountants. The standards were formally adopted by the profession at its annual meeting in September 1948.* These standards have remained in place since that time with numerous statements interpreting them adopted by the Auditing Standards Board or its predecessors. These familiar standards are organized into two general classes: (1) personal or general standards and (2) procedural standards. The procedural standards have two categories: the conduct of the fieldwork and reporting. The objective of this paper is to focus on the procedural standards, in particular, the second standard of fieldwork:

There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the test to which auditing procedures are to be restricted.¹

This second standard of field work pertaining to the evaluation of internal control is interposed between the first which covers planning and supervision of the work and the third which requires evidential matter to be obtained as a reasonable basis for an opinion regarding the financial statements being examined. Its mandate has been subject to considerable interpretations in formal statements which include:

- Special Report by the Committee on Auditing Procedure
  * Internal Control—Elements of a Coordinated System and its Importance to Management and the Independent Public Accountant (November 1948)

- Statement on Auditing Procedure 29
  * Scope of the Independent Auditor's Review of Internal Control (October 1958)

* The fourth reporting standard was subsequently added and approved by the membership of the AIA (AICPA) in 1949.
The profession has issued restatements and codifications in 1954 and 1972 in addition to the SAP 33 codification. These were derived from the pronouncements, including the above, reflecting the development of the auditors' actions.

The significance of the system of internal control has transcended auditor's and management's interest when Congress enacted the Foreign Corrupt Practices Act of 1977 which requires "devis(ing) and maintain(ing) a system of internal accounting controls" for objectives that the auditing profession articulated in Statement on Auditing Procedure 54. Again, in the Report, Conclusion and Recommendations of the Commission on Auditor's Responsibilities, the subject of internal control and its evaluation was extensively commented upon.

In addition, the standard has been the subject of considerable discussion as to whether its requirements are contained in the first and third standards of fieldwork, and thus its listing as an independent standard is confusing to those in practice. This paper will examine the evolution of the second standard as interpreted in the auditing statements and consider whether the intent of the original authors has been changed in the context of providing more precise guidance. Articles and papers exist on the subject, but the discussion developed herein is primarily based upon the officially issued statements of the profession itself.

**Tentative Statement of Auditing Standards—Special Report—October 1947**

In the introduction to the Tentative Statement of Auditing Standards (Tentative Statement), the Committee said:

"Auditing standards may be set to be differentiated from auditing procedures in that the latter relate to acts to be performed whereas the former deal with measures of quality of the performance of those acts and the objectives to be obtained in the employment of the procedures undertaken. Auditing standards as thus distinct from auditing procedures concern themselves not only with the auditor's professional qualities but also with his judgment exercised in the conduct of his examination and in his reporting thereon."4

This distinction has been maintained in the various reissuances of the standards, and may be the reason that the profession has a reluctance to modify or change the original standards. While not entirely comparable, it is interesting to observe in the Attestation Standards, recently issued by the Auditing
Standards Board and the Accounting and Review Services Committee, that the fieldwork standards have been reduced to two by absorbing the internal control concept into an element of the evidence standard.  

In the Tentative Statement, the introductory remarks applying to all procedural standards include a discussion on materiality and relative risk. In particular, the comment upon relative risk on internal check and control is significant as it states that, "The effect of internal check and control on the scope of an examination is the outstanding example of the influence on auditing procedures of a greater or lesser degree of risk of error. The primary purpose of internal check and control is to minimize the risks of errors and irregularities. . . ." The Committee appeared to use this stated purpose as the underlying reason for the second standard. The Committee referred to the Statement on Auditing Procedure No. 1 issued in 1939 which states that, "It is the duty of the independent auditor to review the system of internal check and accounting control so as to determine the extent to which he considers that he is entitled to rely upon it."  

The Committee also stated that, "The review of internal control is one of the most important steps in proper planning of the audit. . . ." The Committee recognized that the study and evaluation is to help plan the approach to evidential matter; yet it did not see fit to include it under the planning standard. I believe it is particularly significant to note the words chosen by the Committee to describe the process envisioned by the second standard: words such as outstanding, primary, duty, one of the most important. These words all indicate a standard that the Committee believed to be extremely significant.  

The Committee also identified the documentation requirements that should be employed in the procedures to evidence the second standard of fieldwork: "A systematic and clear record should be made of the facts developed by the review." This documentation requirement imposed by the discussion on the standard itself again seems to emphasize the importance as to which the Committee attached to the review.  

Internal Control—Special Report—November 1948  

A year later, the Committee issued its special report entitled Internal Control—Elements of a Coordinated System and Its Importance to Management and the Independent Public Accountant (hereafter referred to as the Report). I believe it is worth noting that the Tentative Statement and the Report were issued not as releases under the Statements on Auditing Procedure but as special reports. While the former was directed to the auditing profession, the latter was directed to the public accountant and management due to "the complementary nature of their respective responsibilities and of their interdependence upon each other in discharging those responsibilities."  

The Report indicates that the public accountant's review of the system of internal control serves two purposes:  

First, it enables him to formulate an opinion as to the reliance he may place on the system to the end that, by adjusting his audit procedures accordingly, he may express an opinion as to the fairness of management's financial statements; and, secondly, where the review indicates
apparent weaknesses, recommendations for possible corrective measures may be conveyed to management.\textsuperscript{11}

This section continues with its advice which indicates that:

This secondary aspect of his review frequently enables the public accountant to render broader services than those generally associated with his capacity as an independent reporter to stockholders upon management's conduct of stewardship responsibilities. His aid to management in attaining more efficient operation can and should be an equally important function.\textsuperscript{12}

This duality of purpose, while not stated precisely in the second standard, was, I believe, framed in the Report in the broader context of the profession and its clients for whom services were rendered.

In the introduction to the Report, a statement is made, "In earlier periods the independent accountant frequently had to examine practically all transactions and make dozens of journal entries before reasonably accurate financial statements could be prepared."\textsuperscript{13} This statement was made to establish how internal control had served to impact the audit in producing financial statements, and also assist management in fulfilling its responsibilities. Howard Stettler, in his auditing textbook, observed that Robert H. Montgomery, in his work, felt it necessary to prepare an American treatise on auditing as he had observed in professional practices in the United States, a growing departure from the principles and procedures expounded by Dicksee.\textsuperscript{14} \textit{Dicksee's Auditing} was largely directed to the balance sheet and a determination of the amount of surplus legally available to serve as the basis for the payment of dividends. Montgomery had observed that more was expected of the auditor, and a broader extension of the services of practitioners over the entire field of business activity had resulted. These comments emphasized the broader relationship that the engagement of an auditor by an enterprise had become. The Tentative Statement and the Report represent the culmination of a thought process on the profession's responsibilities to its clients and to society.

In \textit{The Accounting Profession—Where Is It Headed?}, edited by John L. Carey, the role of the auditor is expressed in this context:

The auditor, whether internal or external, plays a strategic role in the discharge of the accounting function. By tests and observation, he ascertains the manner in which the economic data are being measured, recorded, summarized and communicated, and whether all this is in conformity with the established plan. He passes judgment upon records, reports, and the performance of people, all to the end that the output of economic data be sustained at a high level of quality. Without auditing, degeneration of the accounting process sets in.

The auditor also performs another important task—he looks beyond the presently established plan for carrying out the accounting function to determine whether some different or modified plan is called for by changed conditions. Organizations, methods, people, and economic environments are constantly changing; the equivalent changes occur in the actual or potential contribution of the accounting function and in the methods of discharging it. Without auditing, any accounting process is exposed to the risks of losing effectiveness because of obsolescence.\textsuperscript{15}
Statement on Auditing Procedure No. 33—December 1963

The Tentative Statement and the Report remained in place as authoritative auditing pronouncements until the codification in Statements on Auditing Procedure No. 33 (SAP 33) which combined the standards, the Report and the previous Statements on Auditing Procedure into a single document. Therefore, the official position of the profession was contained in these documents for a 15-year-period until 1963.

Chapter 5 of SAP 33, "Evaluation of Internal Control," became the interpretive section for the second standard of fieldwork. The difficulty of the profession's dual role of attest for third party and services to the engaging client caused a significant rewording of the auditor's responsibility for internal control.

This codification now stated, "[a]s a by-product of this study and evaluation (of internal control), the independent auditor is frequently able to offer constructive suggestions to his client on ways in which internal control may be improved." This wording arose in Statement on Auditing Procedure No. 29 which was issued in 1958. The concept outlined in the Report of equality of purpose was now stated as a by-product.

This evolution may have been influenced by a movement that was occurring within the profession: the concept of specialization, and in particular, the concept of management services. In the aforementioned The Accounting Profession—Where Is It Headed?, Carey includes an article by Robert M. Trueblood, "The Management Service Function in Public Accounting" which appeared in the July 1961 Journal of Accountancy. Mr. Trueblood makes the statement:

Independent auditing results in the expression of an expert opinion on financial representations made by management. The CPA bases his opinion, in large part, on a comprehensive understanding and evaluation of management's system of internal control—the systems and procedures used to generate the financial information under evaluation. This expert knowledge of financial information systems and controls is requisite for the CPA's performance of a professional audit. The same expertness that is applied to sound audit performance may also be logically applied by the CPA to management consulting activities.

Over the years, the performance of both the audit and management consulting, or management service, function has been an accepted practice of CPAs. Largely because of the clear connection between the knowledge required to perform a professional audit and the knowledge useful in management consulting activities, the staff performing both activities was frequently the same. Today, however, developments are taking place that tend to force a more explicit delineation of audit and management services activity.

This statement indicating the thrust of the forces of the profession, I believe, has caused the second standard of fieldwork's requirements to move into the area of specialization, and thus, narrow the role of the CPA in his position as auditor of financial statements. This delineation of activity obviously has been much more pronounced as firms grew in size. While the wording of
the second standard remained the same, its interpretation had significantly changed.

**Statement on Auditing Procedure No. 54—November 1972**

The Committee on Auditing Procedure felt it necessary to "Amplify and clarify the application of (the second standard) in the light of subsequent developments in business and in the profession." Accordingly, it issued Statement on Auditing Procedure No. 54, "The Auditor's Study and Evaluation of Internal Control" (SAP 54). This statement reflects the continuing difficulty faced by the profession with respect to specialization and the furnishing of advisory services and audit services directed to the examination of financial statements. Paragraph 2 of SAP 54 clearly states this issue:

The increasing trend for certified public accountants to provide management advisory or consulting services involving the study, evaluation, and improvement of management information systems increases the need to clearly distinguish between these special services and those audit services required for compliance with the auditing standard for study and evaluation of internal control incident to an examination of financial statements. Apparently, the profession's need to compartmentalize activities with a client was a significant driving force to restate the requirements of the second standard. The certified public accountant was engaged as auditor of financial statements or as consultant on systems, and the two functions could not be delivered at the same time. The reasons for this delineation may be subject to considerable speculation. These may include the difficulty of complying with the increasing requirements for financial statement disclosures and information; the difficulty of increasing litigation; or controlling fees. The purpose of this paper is not to reflect on these causes, but they might be the subject of additional research.

SAP 54 stated, "The purpose of the auditor's study and evaluation of internal control... is to establish a basis for reliance... in determining the nature, extent and timing of audit tests to be applied in his examination of financial statements." It went on to indicate:

The study and evaluation made for this purpose frequently provide a basis for constructive suggestions to clients concerning improvements in internal control... Although constructive suggestions to clients for improvements in internal control incident to an audit engagement are desirable, the scope of any additional study made to develop such suggestions is not covered by generally accepted auditing standards.

Thus the concept of the second standard embracing two primary purposes as articulated in the Report and then redefined in SAP 33 as a by-product was further reduced in SAP 54 as incidental and suggesting that a special engagement should result for the study.

SAP 54 also undertook a discussion of how the evaluation mandated by the second standard interfaced with other standards. The other standard which was specifically considered was the third standard of fieldwork covering evidential matter. It is interesting to observe that in the Tentative Statement,
the framers of the second standard noted planning as significant, and as time has passed, it has been interpreted that the study and evaluation of internal control is significantly associated with the evidence standard. Thus, SAP 54 continued the narrowing of effort to the first purpose of the review suggested by the Report and disregarded the second.

Statement on Auditing Standards 43—August 1982

In August 1982, the Auditing Standards Board issued SAS No. 43, Omnibus Statement on Auditing Standards with a section entitled “The Auditors Study and Evaluation of Internal Control.” In SAS No. 43, the Board clarifies its position on “the minimum study and evaluation of the system of internal accounting control contemplated by the second standard of field work” and “[t]he minimum documentation required.” In brief, if the auditor does not plan to rely on the system, he need not document his understanding of the system but only record his reasons for not reviewing. Thus, the most basic sequence is a minimum understanding which need not be documented, but requiring documentation as to the reasons why he did not extend his review past the minimum level which was not documented. The thrust of SAS 43 represents, again, a significant reduction from the original adoption of the standard which indicated that a systematic and clear record be made. In addition, it appears to significantly diminish the second standard’s application in the audit process.

Conclusion

The second standard of fieldwork appears to have embodied a broader concept of engagement of an auditor. This is evidenced in the Report where it stated:

Determining the effectiveness of the organization plan, division of responsibilities, and such special control procedures as budgetary controls, reports, analyses, and cost systems are among the areas which the public accountant should cover in his review. It is not anticipated that the independent auditor will be able to review all the control procedures within the course of any one audit. The review may very well be so arranged as to entail complete coverage over a period of several years. However, the review of those controls which relate directly to the accounting records should, if practicable, be conducted each year.

The evolution of the interpretations of the second standard was to focus solely upon the purpose of financial statement examination and substantially diminish the purpose of communicating with management. While the profession in SAS No. 20, Required Communication of Material Weaknesses in Internal Accounting Control, did require communication of material weaknesses in internal accounting control and evidence a continuing responsibility, it continues to move in the direction of a secondary role of communication at best.

In the Studies in Accounting Research No. 6, a Statement of Basic Auditing Concepts published by the American Accounting Association, the statement is made:
An information system is a necessary subject matter attribute because it is needed to record assertions. Such a system provides a record of the actions or events which is essential to the preparer of accounting information and to the auditor for verification. The reliability of this record is enhanced if it is generated within a system of adequate internal controls. Without such controls, the verifiability standard could be tenuous, indeed.\textsuperscript{25}

In a later section, it is noted that “[t]he system of internal control (is) of paramount importance to the auditor.”\textsuperscript{26} This is another articulation of the significance of internal control to the audit process as well as the management process.

In the Commission on Auditor’s Responsibilities Report, a conclusion is reached that the, “‘Traditional association of independent auditors with annual financial statements is an obsolete, limited concept.’”\textsuperscript{27} This statement is made in the context of expanding the responsibility of the audit function. The Commission would “require the auditor to expand his study and evaluation of the controls over the accounting system to form a conclusion on the functioning of the internal control system.”\textsuperscript{28} Looking back to the Report, such an admonition appears to be a call to return to basics. The formulation of the auditing standards as originally stated seems to me to embody this requirement and only the subsequent interpretations have undertaken to restrict its application. While these restrictions may have arisen from events such as the evolution of specialization in the profession and the impact of litigation as alluded to previously, it still appears that this narrowing diminishes the significance of the audit process and its relevancy to not only third parties, but also the client who has engaged us.

The Statement on Auditing Standards No. 30 states that:

The study and evaluation of the system of internal accounting control in an audit is generally more limited than that made in connection with an engagement to express an opinion on the system of internal accounting control. Nevertheless, an accountant’s opinion on a system of internal accounting control does not increase the reliability of financial statements that have been audited.\textsuperscript{29}

The financial statement report stands on its own at any given point in time. However, as the time frame moves forward, the significance of internal control is increased and management has the right to receive the considered opinion of its auditors. The question of reporting to users other than management has received considerable guidance, but it is independent of the responsibility of reporting to management.

While the second standard of fieldwork gives guidance on the conduct of the “current” audit of the financial statements, it also is giving guidance in reporting to management so that “future” audits would be able to be conducted. Thus, the second standard of fieldwork is necessary to the articulation of our profession’s judgment of this significance, and it should be reemphasized in our professional statements and engagements.
End Notes

1. American Institute of Certified Public Accountants, *Codification of Statements on Auditing Standards*, AU Section 150.02, “Generally Accepted Auditing Standards” (1985).
24. *Codification of Statements on Auditing Standards*, AU Section 323.05.