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Auditing in Educational Institutions

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By Horace S. Ford

The subject of auditing does not appear to have been touched upon at any of our previous meetings—at least a review of the reports of the sessions since 1921 fails to disclose anything of this kind. For this reason, one may presume to approach the subject from any angle he chooses. The approach, as far as this paper is concerned, is from the viewpoint of the business administrator and based upon our experience at the Massachusetts Institute of Technology.

Up to about twenty years ago, the accounts of educational institutions were set up in whatever manner appeared best to those in charge of them. In our case, they "just grew," like Topsy. And when they began to grow fast, and the accounting traffic began to thicken, the old ledgers then in use formed some of the best cross-word puzzles of the time. At least, that is the way they appear to us now, whenever we have occasion to dig into them.

Our first auditing committee was appointed in 1883. We began to print the annual report of our treasurer in 1884. And in 1885 appears the first certificate of an auditing committee—consisting of three members of our corporation. Evidently, the audit of the treasurer's account was not a difficult job in those days, as the auditing committee men themselves performed the task for that year and for the two succeeding years.

Then, apparently, the work became more irksome, and the accounting part of it was delegated to some one, because the "We have examined" of these earlier certificates became "An examination has been made."

It was not until 1897 that the statement indicates the actual employment of an accountant to examine the books, although the committee itself continued for some years "to verify the evidences of personal property held by the Institute."

After another seven years, the committee limited its own work to verifying a single item, namely, the securities that were held by the treasurer.

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In 1897, the first certificate of an accountant employed by the committee appeared. It was not quite as specific as some of our present-day reports.

> "*Gentlemen:* I have completed the examination of the treasurer's accounts for the year ending September 30th, and find them to be correct. I also verified the bank balances. The trial balance corresponds with the ledger balances and the same agree with the treasurer's report as printed.
>
> "Yours truly,
>
> "John Doe, *Accountant.*"

I like that casual reference to "verifying the bank balances," inserted timidly, as if desirous of not hurting the feelings of the treasurer because of having gone around and asked the banks whether their balances agreed with his records or not. And, also, one would infer that it was probably a pleasant sort of a task—that of auditing those accounts on a few Indian-summer afternoons (our fiscal year ended September 30th) with no analyses, nor unit costs nor educational costs hovering in the background. An account was an account in those days, and when an item went into it, it usually stayed "put."

We have changed all that now and know that if we have a $4.00 charge for postage stamps set up against general office expense we shall later be obliged to pick out that item and resolve it into cost per kilowatt hour or per candlefoot hour, or per student hour or per some unit basis that would make the old time accountant wish he had been brought up in the laundry business.

Nor was anybody bothered by such a thing as a budget at that time. The treasurer watched his cash carefully and when it got low, he simply stopped paying some of the bills, or went downtown and borrowed some money, or, in some cases, actually advanced money from his own pocket.

But with all this lack of accounting control (that word "control" wasn't invented then) and the corresponding perfunctory auditing, we, like other institutions, managed to blunder through until about 1907 or 1908 when educational institutions throughout the country became aware of the efforts that the Carnegie foundation was making to standardize forms for making uniform, as far as practicable, the annual financial reports of colleges and universities throughout the country. Particularly those institutions which wished to become affiliated with the foundation and to have their staffs benefit from the proposed pension plans began to sit up and take notice. They began to realize the need and advantages of more thorough accounting and auditing methods than those hitherto followed and also began to get interested in the methods followed by other institutions.

It was undoubtedly at this time that the first few budding things known as questionnaires began to lift their heads above the ground. The inventor of this particular form of irritation probably did not realize that this evil would become so far-flung that today business officers need a McCormick reaper to harvest the annual crop. But, with the growth and development of the institutions and, correspondingly, their accounting systems, the auditing methods had to change also. One man's time and a few quiet afternoons in the fall were not sufficient for certifying to the auditing committees "that the accounts have been verified," much less "that the books have been examined."

At that time, we were fortunate in having already employed for our annual audit the firm of certified public accountants which was then engaged in the task of laying out the schedule for the Carnegie foundation. This, by the way, is the first appearance of the designation "certified public accountant" in our reports. In 1908, this firm, at the request of our treasurer, made a study of our books and accounts and recommended a form of annual report, which comprised the following schedules:—

First, a summary of cash receipts, payments and balances of the fiscal year;

Second, a summary of income and expenses for the year accompanied by such supporting schedules as seem necessary;

Third, a balance-sheet exhibiting the assets and liabilities, divided into three parts—current, investment and plant, together with supporting schedules, as necessary.

Their recommendations were adopted and put into effect the next year, and the schedules in our report for 1910 were as far as we know the first in the country to be published on the standard forms adopted by the Carnegie foundation.

And it is interesting to note here that, except in minor details, the structure of our annual report today, although it has grown from six to sixty pages, is exactly the same as it was in 1909. We believe that the arrangement of the schedules outlined in those recommendations is still good.

The following year, at the suggestion of our auditors, the closing date of our fiscal year was changed from September 30th to June 30th—making one report a nine months' schedule—but thereby helping to establish a uniform closing date for educational institutions and making available the relatively quiet time during the summer months for closing the books and preparing the annual reports.

It will be noted that during this period—at least in our case—the auditing committee has been gradually fading out of the picture, as far as actual contact with or participation in the work is concerned and per contra, the certified public accountant has been stepping down-stage into the limelight and making some definite and useful contributions.

It should be further noted that these recommendations were made, not at the behest of the auditing committee, but because we had a new treasurer, a banker and experienced business man, who read aright the trend of the times and realized that the time had come when the accounting and financial operations of an educational institution should be so conducted and its reports so presented as to picture adequately, not only to the trustees, but to the alumni and friends of the institution and to the general public, the sources of its income, the costs of its operation, and the maintenance of its endowments and its plant.

This was the time when banks were rapidly establishing credit departments, when bankers were beginning to insist upon certified statements of condition and details of operations of firms desiring to borrow money, when organizations in the same lines of business began to swap information and coöperate for mutual advantage, when facts were coming to be regarded as more significant than guesswork.

It was particularly important in our own case to take this step, because our plant shoe was beginning to pinch, holes were appearing at the toes, the soles needed repairing, and it was apparent that, growing as we were, and bound tightly in a very limited space in the heart of a city, the time was coming rapidly when we must move ourselves, lock, stock and barrel, to some more spacious site if we were to meet the demands made upon us.

Also, in common with other privately endowed institutions, we were about to embark on the business of seeking "an angel" or angels—financial aid far in excess of anything that had come before—and while angels are supposed to exist in the air, they may be assumed to have both feet on the ground when they consider turning over large sums of money as gifts to be applied to the cause of education or any other beneficent projects, however worthy. We felt it advisable to set our financial affairs in such order that persons interested would be satisfied that their bequests would be handled wisely and the funds provided administered in as business-like a manner as possible.

We feel that we are considerably indebted to this firm of auditors for stepping into our rather chaotic scheme of things at that time and laying out for us a structure for our financial reports that we have considered good enough to stick to right up to the present.

Their certificate of 1909 is quite different from the quiet statements of the accountant of a decade before. I quote from it to show to what extent they had laid their hands on our business administration, and the entirely different conception of their duties may be inferred from the following:

> "We have established" (not verified) "the assets and liabilities as set forth on the balance-sheet included in our report to the treasurer and have brought the ledger accounts into agreement therewith." (The certificate does not indicate whether willingly or unwillingly.) "We have verified the vouchers for disbursement, have satisfied ourselves that all receipts of money have been acknowledged on the books and deposited in the banks, that the cash balances of September 30, 1909, were actually available and that these balances were correct." (There is nothing indefinite about that!) "We have verified the details of bookkeeping during the year, have re-arranged the methods of accounting in various respects and have prepared the report of the treasurer upon schedules submitted herewith."

I think you will admit that there is a get-up-and-go spirit about this certificate and a finality to it that indicates that things were really being looked into, that a reconstruction of accounting methods was in progress, that the whole accounting concept both from the auditors' point of view and from the institution's was changing rapidly. Our auditing committee evidently got a favorable reaction from it, because they continued to employ this firm over a period of years and only recently changed, as will be explained shortly. And you will note that the auditors actually prepared the treasurer's report—every last figure of it—in addition to verifying all the details of bookkeeping during the year. This took a lot of time and of course the whole job cost quite a bit of money, but the results justified the expense.

There was, however, no budget on the scene as yet, and the treasurer still held the key to and was personally responsible for the contents of the strong box at the bank wherein were deposited the stocks and bonds that were listed in the investment assets. The actual operating methods were little changed from those of a decade before.

For the next two years, the auditors performed their duties in exactly the same manner and then in 1911, new conditions and new prospects forced the first of what might be termed present-day methods of auditing.

Our endowment funds had been increasing rapidly and one of the tasks that the treasurer found it necessary to perform personally was to clip the coupons from about $2,000,000 of bonds in which these funds were invested. There were few stock certificates in our list at that time. This business of clipping coupons is great sport if they happen to be your own (that is, I imagine it might be) but the meanest job there is if pursued regularly for others, even in the service of as worthy a cause as higher education.

Our treasurer of that day evidently felt that way about it. He also appreciated the services that a well organized trust department of a banking institution can render in excess of being a mere custodian of securities, and at an expense that is, even today, a modest one.

At any rate, the executive committee saw his point and duly authorized him to appoint one of our large banks as his fiscal agent, as far as our securities and other valuable records were concerned.

This was the first cut into the details that the auditors were "verifying" each year, for after a check-up of these securities at the end of the first year of this arrangement, they were thereafter relieved of this duty, accepting in lieu thereof the bank's certificate and checking this to the treasurer's books.

Our practice now is to have these securities actually viewed and checked about every three years, although from some familiarity with the systems of internal checks in the handling of securities that have been established by up-to-date banking institutions, it is questionable whether even this precaution offers any further safeguard. We regard the certificate of the bank covering the securities held as sufficient and as satisfying as its certificate of credit balance.

The next cut in the auditors' work came shortly after, when the actual making up of the schedules of the treasurer's reports went back to the office staff. This, by the way, is exactly as it should be—the treasurer setting up his own report and the auditor verifying the details and, of course, offering any criticisms or suggestions that may occur to him. It is up to the treasurer to adopt or reject any of these suggestions but we have always encouraged and welcomed constructive criticism and shall, I trust, continue to do so.

Now we reach 1915 and along comes our friend, the budget system. Ours was a limited budget at first, and covered only the academic department appropriations and the teachers' salaries. It still left much to be desired. It was one of the "watch and pray" sort of budgets. One watched his income and expenses as closely as he could, and prayed that when the final whistle blew at the end of the year he would find a smaller deficit than he expected. We still continue to watch those items as closely today, but thanks to the accounting controls which the operation under a complete budget system not only encourages but absolutely insists upon, we are able to direct some of our prayers to less melancholy and more worthy purposes.

A year later we picked up our goods and chattels and literally trekked from Boston to Cambridge—2000 truck loads of educational lares and penates, to be assimilated with as much more that was new. And our accounting system had practically to be reconstructed to fit the new facilities and conditions into which we stepped. Dormitories and dining service, the operation of a student union, a centralized stock room and service bureaus, a central power system and organized laboratory services all came into the accounting picture with a rush.

Before we had time to acclimate ourselves, financially or otherwise; before we had time even to break in additional members of the business office staff the war swept all routine matters into the waste basket.

For the purposes of this paper, it is only necessary to recall the maze of paper work with which the war schools, the students' army training corps and other activities flooded our offices. We went through the usual motions, budget and all. But the budget soon went into the river along with most of the other well laid plans. My personal recollection of that period is a never-ending stack of public voucher forms in quintuplicate with first, second and third endorsements—in for signature, out for payment, back for correction, returned for payment, back for something else—however, enough of that! I could sum it all up in one word, but Sherman said it first.

Beginning with 1919, we again took up the disorganized threads of our accounting system with the idea of proceeding from where we left off, only to find that almost twice as many students had descended upon us. Any business that doubles itself almost overnight will find some strain on its accounting methods, and we proved no exception to this rule. Particularly our methods of registration and student payments showed the need of revision, and that rapidly. But we had learned something by the inevitable speeding up incidental to the rush of the war days and in this case we effected a complete change in our system of registration, payments and student accounts, without calling in any outside accountants. It is pleasing to record that the whole plan was based substantially on the suggestions offered and criticisms made by the members of the office staff—the people who actually operate the scheme. I wish to record here that we now practically never make a change in our accounting practice and methods without first getting the opinions and suggestions of those of the staff who are to operate under such a change. Every member of the staff is encouraged to offer suggestions for more effective operation of the office work at any time. It not only creates a better feeling among the employees but also serves to gratify that desire that everyone has, no matter how humbly employed, of originating something and seeing it work.

And now the date is 1921 and we have a new auditing committee with a chairman who has no intention of accepting a rubber-stamp job. The first thing the committee did was to buy a new broom and the dust began to fly right away. The auditing committee had been in the background for some years. It now decided that the time had come when the committee should contribute something to our financial scheme of things.

First, they recommended that the annual audit be turned over to another firm of accountants on the general theory that it is well to have now and then the quickening that comes from new points of contact, new accounting views. Familiarity on the part of an auditing concern does not necessarily breed contempt but may reasonably be expected to take many things for granted that a new firm would quite properly ask to have explained in detail.

Next, they suggested an entirely new step, namely the employment of an experienced accountant "to make a careful study of the work of the treasurer's office, to determine whether the accounting and audit system, as operated, provides sufficient control of receipts and expenditures." No actual audit in detail was attempted, as this would nearly have duplicated what already was being taken care of annually. Methods of recording receipts and payments were studied and the route of each class of items was traced to discover if the system followed gave sufficient control and safety—and with a reasonable amount of clerical labor.

Please note that last remark. It was the first time in our history that anyone outside the office had ever dared to bring up the question of whether the office was economically operated with direct reference to the work performed or not. And this inquiry was not prompted by any feeling that the office was not properly run. It simply represents another forward step in auditing methods.

I may say that we were very well pleased to have our auditing committee interested in this and also to get the benefit of the ideas and suggestions of the able man who was charged with the task, one who was qualified to weigh the operations in the light of his experience. An outside contact of this sort is always helpful and it proved so in our case.

It is this kind of examination combined with the annual audit that is the more effective method of auditing that I have been leading up to in the eight or nine pages of this paper. We have been so convinced of its usefulness that today, with both the approval and consent of our auditors, we have eliminated a large amount of the actual checking of details of the bookkeeping and accounting transactions, and we have had the accountants devote more of their time to a review of the accounting methods and satisfy themselves that the internal checks are adequate and that the accounting controls actually control.

This does not mean that we have done away entirely with the other and older phases of auditing. In addition to this report on the accounting methods they examine our books and records for the purpose of:

(1) Verifying the financial condition of the institute;

(2) Making test examinations of operating transactions during the year to determine their propriety and accuracy;

(3) Reporting on the extent to which their recommendations of the previous year have been adopted.

An audit of this kind serves to keep our auditing committee, and through that the corporation, informed of the financial operations and the financial status of the institution; to keep the employees of the treasurer's office on their toes and alive to the best methods of installing and maintaining internal checks and accounting controls which, if rightly set up, are in themselves more perpetual instruments of detailed audit than any outside firm coming in at the end of the year can possibly offer, and finally, to bring all the outside experience and information that an up-to-date auditing concern is bound to accumulate and make this available for application to any part of the office practice and accounting methods that need strengthening.

Incidentally, we have found that with this sort of audit we are getting much better value for the expense involved. If we had continued the auditing methods of 1909 we should have the annual examination last almost the year through. If we thought that such a detailed audit was necessary, it would be an admission of a complete lack of internal checks and controls that cover such items as payrolls, inventories, service bureaus, laboratory services, receipts from students for tuition and other fees, dormitories, dining service and all the other active accounts. Probably two-thirds of all the checking of bookkeeping and accounting details are now taken care of internally and are not actually verified by the auditors.

The installation of the budget system, now universally accepted, is in itself an internal check of the first order and is probably responsible for the change in the type of audit more than any other single item. To set up and operate a budget properly requires not only an effective system of controls, but also complete analyses of receipts and expenditures, and such analyses are best made by keeping them up continuously, exactly as a perpetual inventory is kept up.

These very operations and the resulting necessary internal oversight have taken away from the auditing firms the long, dreary days of checking details and have substituted the more interesting work of reviewing the methods set up and their capacity to safeguard the financial operations.

In closing, I wish to say that the story of our auditing experience and the observations thereon are not offered as a panacea to any other institution which may have had unsatisfactory results in its relations with its auditing committees or with the auditors.

We learn by our own experience and that of others. This is simply the experience of another.