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THE S. E. C. LOOKS AT INTERNAL CONTROL

Address of

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Some eight years ago Mr. Wertz, then Chief Accountant of the Securities and Exchange Commission, spoke before the Second Annual Conference of the Institute of Internal Auditors. 1/ At that time internal auditing was just passing from an early stage of resurgence to a period of rapid expansion and renewed recognition. It is a pleasure to represent the Commission in a discussion with a group that in the short eight-year interval has contributed so much that is new in accounting development.

In view of the latitude permitted by tonight's subject it is proposed not to suggest further avenues of progress or the details by which existing goals might be reached, an aim that would be highly attractive, but rather to make a very brief review of internal control. In so doing the emphasis is to determine how an auditing development of mutual interest to internal auditors and the Commission came about with the intention that certain relevant standards as presently viewed by the Commission may thereby be explained.

The Commission's governing rules as to the certification of financial statements are contained in Article 2 of Regulation S-X. Requirements relating to the representations to be contained in the certificate, to the audit standards to be observed and to the scope of the audit are specified in Rule 2-02 of the Article. It is under the latter category that matters pertaining to internal control are considered. As a means of developing the Commission's viewpoint as to the relationship of internal control to the objective of investor and public protection, it may be helpful to explore the existing and prior rules to the extent they touch upon internal control. At the same time it may be useful to examine their antecedents as found, first, in Commission practice and, second, in the development of the profession.

Prior to amendment last December, Rule 2-02 (b) of Regulation S-X contained the following paragraph:

"In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The independent public accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed."

1/ Wertz, "Viewpoint of the S.E.C. on Internal Auditing," 76 J. of Accountancy 470 (Dec. 1943).

As a part of the general revision of the Regulation announced in Accounting Series Release 70, this paragraph has now been deleted from the Rule. However, it will be readily evident to accountants familiar with Article 2 and with professional practice that the requirements and permissions as to internal control theretofore contained in the Rule are in no degree altered. Rule 2-02 (b) still requires in effect that generally accepted auditing standards form the basis of the audit and of the representations of the accountant expressed in the certificate with respect to financial statements filed with the Commission. The specifications contained in the omitted paragraph.. form a positive part of requirements developed over the years, and are now permanently and specifically codified in the standards formally adopted by the public accounting profession. ^{2/} Therefore, the simplification of the Regulation by deletion of the paragraph was deemed appropriate.

The provisions contained in the deleted paragraph are very important. The earliest portions, ^{3/} which had been included in prior requirements since January 1935, were those to the effect that the certifying independent public accountant may give due weight to the internal system of audit and must determine that the accounting procedures professed to be followed by the client are in fact being followed. It had been felt that only these matters pertaining to internal control might need explicit treatment by rule, since internal check had long since received definite professional recognition.

In 1941, notwithstanding this fact, the Commission added to the paragraph the positive assertion that the auditor must give consideration

^{2/} Statement on Auditing Procedure No. 24 (1948), American Institute of Accountants, particularly the resolution adopted by the membership of the Institute. See also Internal Control (1949), a special report of the Institute's Committee on Auditing Procedure, and Audits by Certified Public Accountants (1950), a booklet prepared by the Research Department of the Institute as a successor to Examination of Financial Statements published in 1936 by the Institute.

^{3/} For example, Form A-2 (now superseded by Form S-1), for several years the principal form in use under the Securities Act of 1933 for the registration of securities to be sold. Like provisions existed in the early forms for registration and annual reports under the Securities Exchange Act of 1934.

to the adequacy of the system of internal check and control in determining the scope of his audit. ^{4/} In the adopting release the only comment of the Commission as to this extension indicated that its purpose was to emphasize "the importance of this basic element." It will be recalled, however, that this was but one of a number of basic changes effected at that time in the certification requirements contained in Rule 2-02. The Commission pointed out that the amendments had been under consideration for some time, and in discussing the changes quoted rather extensively from its Report on Investigation, In the Matter of McKesson & Robbins, Inc., (1940). The amendment in question obviously therefore was made not simply to introduce the terms "internal check" and "control". It may be concluded that the change reflected the Commission's feeling that the standards in this area were not as widely followed at that time as had been supposed. The amendment accordingly may be viewed as intended only to make explicit what had been regarded as generally accepted, to remove any indefiniteness of the then professional requirements and eliminate the substantial diversity of practice found to exist.

It perhaps should be noted that in the days when the Commission's rules were first being prepared, which was some time before the many developments that have grown out of the organization of the Institute of Internal Auditors, there did not exist the careful delineation of terms later provided by Brink, Cloake and others. It is from this quite recent development that internal check is perhaps generally recognized as essentially a feature of the accounting system, internal auditing as an organized, supplementary activity, and internal control as the broad plan, of which the other two are a part, by which management constantly seeks the highest measure of operating efficiency. ^{5/}

As a means of developing both the origin and the present status of the Commission's views it may be appropriate to consider briefly some of

^{4/} Accounting Series Release No. 21.

^{5/} Cf. Brink, "Internal Check," 67 J. of Accountancy 138 (1939); Internal Auditing, 1941; Managerial Control Through Internal Auditing, 1943. See particularly the excellent discussion by Cloake in "Internal Check and Control as Distinguished from Internal Auditing", 12 New York Certified Public Accountant 616 (1942).

the historical background contributing to the growth of reliance upon internal check, internal auditing, and internal control. ^{6/} Many of the developments relate to features which, if not seated in antiquity, at least trace their origin back many years, even centuries.

Auditing, like accounting, is not only a social force but grew out of social as well as business problems. Taking human beings for what they are, it is entirely probable that internal check and auditing in their most primitive forms developed almost simultaneously with the earliest beginnings of bookkeeping. An interesting anecdote of history, for example, is that embezzlement, which according to Bennett is a strictly statutory concept, was first made a crime in England during the reign of Henry the Eight (1509-1547). ^{7/} In any event it is clear that in the fourteenth, fifteenth and sixteenth centuries, if not before, a limited form of auditing existed in Britain. ^{8/} It was largely but not exclusively concerned with government and the business affairs of the large manors then so dominant. Littleton has characterized it as "designed to verify the honesty of persons charged with fiscal, rather than managerial, responsibilities," in other words, "a check upon 'accountability' and nothing more." ^{9/} The objective of the "audit" could only have been to verify the accuracy of reported collections and disbursements of funds by appropriate officers. In a sense one might say that in the case of the English manors the auditing was performed by internal auditors; for the auditor, undoubtedly a regular employee of the lord, regularly examined the accounts of the receiving and disbursing officer and checked them against the established sources of revenues (rents, tolls, fees) set down in detail by a third officer. ^{10/}

^{6/} For this purpose the research of Littleton, Accounting Evolution to 1900 (1933), will be drawn upon considerably.

^{7/} Bennett, Fraud, Its Control Through Accounts, 1930, pp. 14-15.

^{8/} Historians apparently find little relationship between English practices (with which this review must be primarily concerned) and the remarkable results achieved in the period in Italy as epitomized in the first treatises on double entry bookkeeping by either Paciolo in his De Computis, published in 1494, or by the work of Cotrugli, completed in 1458 and published in 1573. For these treatises see Peragallo, Origin and Evolution of Double Entry Bookkeeping, 1938.

^{9/} Op. cit., p. 260, 264.

^{10/} Cf. Sir Walter Henley's Tretyce off Housebandry, an excerpt of which is contained in Dicksee's Auditing (1902), p. 765, showing that the duties of the auditor of the thirteenth century were quite remarkably similar to the duties of the auditor of today.

Historians have related much of the early accounting history to the extensive commerce coming in the wake of the crusades. An essential change in the scope and objective of auditing no doubt occurred in the next period, broad social and economic changes again clearly providing the causitive background. Thus, in the time measured very roughly by the seventeenth and eighteenth centuries, the environment of auditing (as identified with private business) underwent profound changes. In Britain as elsewhere, the craft guild type of personal production came to be displaced by the early forms of the factory system in which small owners hired workers and paid them wages to convert the owners' materials to salable products in the owners' establishments. From receipts and disbursements and accountability in a personification sense there now was introduced the factor of ownership. This carried with it new problems as to assets and liabilities (ownership) and profit determination. Thus, auditing, once a process concerned with the satisfaction of accountability because of the new enviroment "now began to lay increasing emphasis upon the visual scrutiny of written records and the testing of entries by documentary evidence." 11/ Perhaps the crowning event of the period was the replacement of hañd tools by power driven machinery and the associated changes in agriculture, industry, trade and transportation beginning in England after 1760 - the Industrial Revolution. In any event, it may well be concluded that the circumstances of this period established the substantial basis for the external auditor and, of course, the substantial need for internal check and control as it may be thought of today.

For purposes of this review the next period of development might be considered as including the events up to the time of the consolidation in England in 1880 of several societies of accountants into the newly organized Institute of Chartered Accountants in England and Wales. It may be said that it was in this period that the accounting profession was born. The background is still essentially British; for there was the heart and dominance of industry, trade and banking, the necessary ingredients for accounting opportunity. Joint-stock companies had existed for many years and considerable impetus to their formation followed the experiences of the East India Company and others at the beginning of the seventeenth century. The really great expansion of these companies, however, began early in the nineteenth century. With

11/ Littleton, op. cit., p. 265.

this expansion also came successive waves of business failures and nationwide crises. The need, not to mention the cry, for controls, internal and external, was tremendous. Huge investor losses and the accompanying bitterness instilled widespread demand for reform. Out of the many resulting changes in the British bankruptcy laws and laws dealing with business associations, there arose the British statutory conception of an audit by a stockholder (1844-1845) who, by holding no office in the concern, would be independent of the management. 12/ This, however, was only slight improvement over the meager protection afforded by the work of the theretofore alleged auditors. The patent inability of lay business men to cope with the problems presented, despite technical assistance, rapidly advanced the cause of the truly expert accountants, a very small but growing group now appearing on the scene. It was to them that the business and investing population found they must turn. 13/ These circumstances, including the founding of the professional societies and the bare beginnings of an auditing literature seem to mark the emergence of the modern independent auditor. 14/ 15/

12/ In 1862 the provision as to stock ownership was abandoned in revised legislation.

13/ The term "auditor" enjoyed various degrees of respect. In 1913 Dickinson in Accounting Practice and Procedure suggested that it might be wise to abandon the term in referring to public accountants. (p. 231)

14/ Sir Laurence Halsey, Dickinson Lecturer, 1937-1938, noted that the 1845 and 1862 legislation pertained only to railroads, other companies not being compelled to have their accounts audited until the Companies Act of 1900. He added, however, that this "probably only confirmed existing practice." Dickinson Lecturers in Accounting, 1943, pp. 59-60. That these optional features of the pre-1900 legislation were virtually compelling on all companies seems clear from the language of the 1845 and 1862 Acts indicating that in the absence of contrary public notice the public could assume that mandatory requirements for an audit were included in charter provisions.

15/ This marking of the beginning seems logical despite the fact that public accounting was legally recognized in Italy in the latter part of the eighteenth century, in Uruguay in 1825 and in Argentina in 1836. See Raunsaville, "Some Little Known Facts About How Accountancy Got To Be What It Is Today," 88 J. of Accountancy 232 (Sept. 1949).

Although auditing and many of the internal corporate complements thereof were essentially British in origin, its development in the United States was equally inevitable. The modern corporate form of business organization in which completely limited liability prevails came into existence in the United States about a half century before its full acceptance in Britain. The pressures that bring reform, however, were not present in this country at the time they were across the Atlantic so that the growth of auditing here followed rather than paralleled that in Britain.

But the evolution of auditing in this country contrasts with British experience in other respects. In Britain the historical emphasis of auditing, from the time joint-stock companies in the seventeenth century began to abandon limited-life charters in favor of stock transferability, has always been upon shareholder control of management, upon the determination of the proper discharge of management's responsibility to shareholders. In the United States, however, auditing evolution from inception to, perhaps, the early 1930's has been largely associated with quite different compelling forces. These were, primarily, the influence of factors associated with the granting and extension of credit and banker protection in securities underwriting. 16/ Perhaps, secondarily, there might be included American management's own characteristic search for efficiency in carrying out its functions, a characteristic, indeed, that is reflected in the definition of the substantive nature of internal auditing as contained in the Statement of Responsibilities of the Internal Auditor approved July 15, 1947, by the Directors of the Institute of Internal Auditors, Inc. 17/ This characteristic is also one that, in terms of the broad evolutionary process of, say, the last seventy-five years, would also seem to be reflected in the work of American public accountants.

Original association of British auditors with the stockholding interest, however, gave a professional character and independence to the auditor that was somewhat slower in recognition, if not development, in this country. Although the basic differences between British and American auditing are perhaps not as great now as they were, there may still be some question whether in American practice the historical

16/ In this connection see May, Twenty-Five Years of Accounting Responsibility, 1936, p. 4.

17/ See 85 J. of Accountancy 468 (June 1948).

approach from the management side has yet reached the same level of an audit of the management as in the British case where, historically, auditing the management was the starting not the ending point.

With this very general background, examination of subsequent historical development may be confined to the more concrete progress in the development, or at least recognition, of internal control as an aid to business either directly or indirectly through its independent, external auditors. As early as 1902, in a Fifth Edition to his Auditing, Dicksee, the English author, gave very specific attention, though but a page of space, to the subject of internal check. He wrote:

"General System of Internal Check.--This is a matter that may very profitably engage the careful attention of the Auditor, for not only will a proper system of internal check frequently obviate the necessity of a detailed audit, but it further possesses the important advantage of causing any irregularities to be corrected at once, instead of continuing until the next visit of the Auditor, which--even in the case of a continuous audit--is clearly a consideration. It is very probable that the Auditor will be asked to make any suggestions that may occur to him for the improvement of the existing system of accounts, or in the case of a new undertaking he may be invited to prepare a system for the use of his clients." (p. 36)

After mentioning three elements that any system of internal check should include he observed:

"With a system of accounts arranged upon these lines, a detailed audit is frequently unnecessary, but it is always desirable that the Auditor should satisfy himself that the system has actually been carried out in its entirety, and sections of the work should be fully checked at unexpected times." (p. 36)

Dicksee's auditing book had wide influence in the United States and two American editions thereof by Montgomery preceded Montgomery's own authorship in the field in 1912. By that time there was a definite recognition by Montgomery of the fact that internal check was both a valuable supplement to the detailed audit then so common and a major factor factor in making the so-called balance sheet audit possible. 18/

Perhaps the first mention of internal check by an authoritative American body was in a memorandum prepared by the American Institute of Accountants which appeared as "Approved Methods For the Preparation of Balance-Sheet Statements" published in 1917 by the Federal Reserve Board. In the general remarks at the end of the memorandum the following statement was made:

"These instructions cover balance sheet audits of small or medium-sized concerns. In large concerns having, for instance, tens of thousands of accounts or notes receivable, the detail procedure suggested would be impracticable, and internal check should make it unnecessary."

Full and complete authoritative recognition of internal check would appear to have come with the 1929 revision of this important milestone of accounting. This was again undertaken by the American Institute of Accountants under the title "Verification of Financial Statements". In the opening paragraph under the heading of "General Instructions" the following statements were made:

"1. The scope of the work indicated in these instructions includes a verification of the assets and liabilities of a business enterprise at a given date, a verification of the profit-and-loss account for the period under review, and, incidentally, an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check.*** The extent of the verification determined by the conditions in each concern. In some cases the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice. The responsibility for the extent of the work required must be assumed by the auditors."

Similar comments are contained in the Institute's successor bulletin, "Examination of Financial Statements," published in 1936. To the words "internal check" there were added "and control". There was contained, also, an elaboration of the nature and meaning of internal check and control (the latter term apparently being added largely for its descriptive value). For the first time an indirect reference to the work of internal auditors was included. This is to be inferred from the following: "The detailed scrutiny and check of cash transactions of large

companies can be performed more economically by permanent company employees. Where such a check is provided, the accountant will modify his program accordingly." This observation was followed by the highly important injunction that, except in very small organizations, "no examination should be regarded as taking the place of sound measures of internal check and control."

The foregoing review extends slightly beyond the initial years of the Commission's existence and particularly the first rules of the Commission in which internal check and control were associated with the certification of financial statements. However, authoritative documents of this sort almost always represent codifications of a relatively high level of existing professional practice. This is probably also true only in a slightly lesser extent in the case of other literature. Thus Dicksee, in his first edition (1892) reproduced the standard set of audit instructions used in the office of the then late David Chadwick, F.C.A. (after upwards of fifty years experience). The first four of his twenty-two instructions were as follows:

"1. In commencing a new audit you should obtain a list of all ~~the~~ books kept, and of all persons authorized to receive or pay money and order goods.

"2. In the case of a joint stock company, examine the articles and board minutes respecting the receipt and payment of money, and the drawing of cheques, acceptances, &c.

"3. Ascertain and take note of the general system upon which the books are constructed, and the plan of checking the correctness of the accounts paid, and whether exclusively or generally by cheques.

"4. Report if the accounts and vouchers are submitted to the board of directors by an account committee or otherwise, and whether they are systematically checked and certified; and note any discrepancies."

These instructions and the comments of Dicksee previously mentioned are all the more remarkable in that the concept upon which British and early American auditing method was based was that of the detailed audit.

As Short has ably described, 19/ there was a rapid transition in the United States first to a test type of detailed audit and then to the "analytical examination" in which, as a general proposition, audit of individual transactions either was subordinate, if not eliminated, or was resorted to only where proof of the balance sheet item was not obtained by other means. The truth of this can readily be seen from a study of audit procedures employed over the years and of authoritative pronouncements, some of which have been mentioned. The role that internal check and control occupied in this transition should be very evident.

With the foregoing brief historical review of auditing development there is established the considerable background that existed at the time the Commission's accounting responsibilities came to be established. In prescribing, as it soon found necessary, some of the primary guides for the proper certification of financial data, it was inevitable that recognition would be given to the standards then in existence that had been adopted and tested over a long history of trial and error and public experience with business methods. The Commission had no need to break new ground. The guides were already firmly established, if not always honored in given instances, and it remained only for the Commission to ensure that the proper application of the guides could be depended upon. The historical review shows clearly that among those that had long stood the test of time may be included the proper reliance for protective purposes upon internal control.

With respect to internal control the emphasis of the Commission's rules from the very outset was not, indeed, could not have been, upon a permissive intent in the statement that "due weight may be given to an internal system of audit. . . ." To the contrary, the evidence is that the emphasis was upon the limitation against excessive reliance. Moreover, in insisting that there be a verification by the certifying accountant of the actual application of internal procedures the Commission simply expressed the logical and acknowledged viewpoint of the accounting profession that to be of value in the protection of investors and others the procedures upon which reliance is placed must be followed in fact and not simply exist as an instruction, a good intention or an ideal. 20/ The hard reality of business experience, probably long antedating even Dicksee, proved the wisdom of this view.

19/ Short, "Internal Control from the Viewpoint of the Auditor", 70 J. of Accountancy 225 (Sept. 1940).

20/ Note the following comments as early as 1924 by Bell and Powelson in their Auditing: "The auditor should be careful not to be misled by indications of internal control when in fact it may be non-existent or purely perfunctory. The office personnel may include an 'auditor' but it does not follow that there is any effectual control over even the disbursement of cash . . ." (p. 39)

As has already been indicated, as a result of conditions disclosed in part from the McKesson & Robbins case the Commission found that it was desirable to emphasize by means of a rule one further requirement respecting internal check and control. This was that its adequacy must be given appropriate consideration by the certifying accountant in his determination of the scope of the audit to be made. This rule reflects the feeling on the part of the Commission that under certain conditions even detailed auditing of transactions may not provide the necessary substantiating evidence to justify audit certification if internal checks or controls are absent. Indeed, in reviewing one aspect of the McKesson & Robbins case the Commission commented upon the possible value of a further extension of the type of detailed inspection of documents and transactions that had been done. It indicated that in its judgment such extension would not have substantially increased the likelihood of disclosure of the particular fiction that existed. ^{21/} There is no doubt that in many areas there is no equal or substitute in auditing for the safeguard afforded by proper internal control methods. ^{22/} Moreover, investors are entitled to know of material omissions under these conditions.

As has many times been stated by professional leaders and the Commission, financial statements are primarily the representation of the management. This the Commission reiterated in the Interstate Hosiery Mills case ^{23/} and it has been stated and restated many times by the American Institute of Accountants. ^{24/} Nevertheless, as is now universally recognized, the responsibility for determining the scope of the audit necessary to the expression of an opinion by the certifying accountant lies entirely with him. Clearly a proper discharge of the duty thereby involved requires that the adequacy of the operating system of internal check and control be taken into account. ^{25/}

^{21/} "As we view the situation in this case, a detailed audit of all transactions carried out by the same staff would merely have covered a larger volume of the same kinds of fictitious documents and transactions. While this might have brought under review more instances of what we have listed as circumstances suggesting further investigation, there is little ground for believing that this alone would have raised any greater question as to the authenticity of the transactions." In the Matter of McKesson & Robbins, Inc. Report on Investigation, 1940, pp. 10-11 (also in Accounting Series Release 19).

^{22/} For a comparable statement see May, Twenty-Five Years of Accounting Responsibility, 1936, p. 140.

^{23/} 4 S.E.C. 706, 721 (1939).

^{24/} See, for example, Extensions of Auditing Procedure (Statements on Auditing Procedure No. 1), 1939.

^{25/} As a result of the McKesson & Robbins case and in connection with Extensions of Auditing Procedure (note ^{24/}) the Institute amended its
(continued)

It has been said that internal auditing, where it is employed, is an integral element of the broad activity and measures now contemplated by the words "internal control". It is manifest, therefore, that insofar as the work of the internal auditor assists in establishing the reliability of financial records and data the independent certifying accountant -- the external auditor -- must be vitally concerned. A complete review of this work and an evaluation of it in terms of the scope of the external auditor's work is clearly mandatory. This does not mean, of course, that his reliance upon the internal auditing automatically follows; for this involves a decision that rests peculiarly within the judgment of the external auditor.

So much has already been said in contemporary accounting literature about the relationship of the internal auditor and his work to the external auditor and his certification that additional comment is bound to be repetitious. It may be worthwhile, however, to observe briefly again a few points that in the light of the Commission's objectives bear emphasis.

Internal auditing is an element of internal control that, through proper planning and execution, may in appropriate instances be relied upon by the external auditor. It is not a substitute for the work of the external auditor. But since the objectives of both internal and external auditors include establishing the reliability of the company's financial records, intelligent planning by both auditors may materially increase the usefulness of the one to the other. In particular such cooperation should enable the external auditor to perform the maximum service at reasonable cost. On the other hand, it is agreed that advance commitments cannot be made by the public accountant as to the nature or extent of his review; moreover, there are certain minimum procedures to be performed by the external auditor that no amount of work by internal auditors can justify eliminating. Cooperative efforts cannot go so far as to prevent some overlapping and duplication of work.

Internal auditors may not possess in the degree that public accountants do all the advantages that derive from frequent contact with many and varied businesses. They have, however, the intimate knowledge of and continuous contact with the problems of their own business that contributes so much to the efficiency necessary to the economical audit of great volume. For the same reason they are ideally qualified to effect desirable refinements of internal control procedures. They are especially

25 Cont'd/

recommended form of the certifying accountant's opinion to include the positive assertion that the system of internal control and the accounting procedures of the company had been reviewed. Later amendments required the representation that the audit was made in accordance with generally accepted auditing standards and included all procedures that the auditor deemed necessary. Statements on Auditing Procedure 5, 6, and 12.

qualified to maintain the vigilant supervision necessary to prevent breakdowns of essential features of the system of internal check.

Independence, as one writer put it, the "stock in trade" of the public accountant, ^{26/} is also the principal asset of the internal auditor and without which there is serious impairment in the usefulness of his activity to the public accountant. This quality must differ somewhat from the type or degree of independence expected of the certifying accountant, but essentially the only difference lies in the necessary interest of the internal auditor in his employer and the necessity of identification with the management at a top level. The internal auditor's usefulness as such either to his employer or to the public accountant is doubtful if he is charged with performing current operating duties or if his responsibility to a top level of management is marred by the slightest right of suppression from an operating area subject to audit. The greater the objectivity attainable by the internal auditor, the greater will be the extent that the external auditor may rely upon the other's work in determining the scope of his work. A considerable freedom of professional judgment is entirely possible despite the fact that the internal auditor is an employee. It is this kind of judgment that can be useful to the certifying accountant who, in permitting his certification to be filed with the Commission, is himself charged with heavy professional responsibilities. There is evident a commendable willingness on the part of internal auditors also to accept responsibility, although necessarily of a different character. This attitude is shown by the literature of their leaders and by the official pronouncements of aims of the Institute of Internal Auditors.

It may be desirable to take note of the fact that internal auditing staffs are to a rapidly growing extent being utilized for purposes considerably beyond the scope of traditional internal control in the strict sense that it contributes, via the public accountant's certificate, to investor and public protection against fraud. This extension is in the direction of operations study or the analysis of performance and execution of policy in various phases of the company's operations. ^{27/} One writer suggested that: "Insofar as the word 'auditing' limits its scope to traditional accounting subjects, the term 'internal auditing' is already obsolete." ^{28/} This is, of course, incidental. Insofar as this new concept of services aids management, the position of the internal auditor will be materially enhanced, a prospect certainly not inconsistent ^{26/} Hurdman, "Independence of Auditors," 73 J. of Accountancy 54, 60 (Jan. 1942).

^{27/} See, for example, Jones, "The Internal Auditing Function," Report of Annual Meeting, Financial and Accounting Committee, American Petroleum Institute (1950), p. 51.

^{28/} Garbade, "Internal Control and the Internal Auditor," 19 Accounting Review 416, 421 (Oct. 1944).

with any interest the Commission may have. Since the extended concept does not bear directly upon the objectives of the Commission it may only be desirable to suggest that the external auditor may be required, because of his responsibilities, to be particularly alert to any encroachment upon the internal auditor's objectivity resulting from a possible involvement in operating policies or responsibilities.

In these brief comments nothing has been said respecting particular procedures of internal control. Although the Commission must necessarily be very interested in procedures, whether of internal check or of internal auditing, and the extent of reliance upon them by independent public accountants, their development is the primary concern of management. No doubt they will be refined much more, particularly in the internal auditing area, in cooperation with the external auditors, and where occasion requires, under the scrutiny of the Commission as a representative of the investor and public interest. 29/ The cooperative efforts of internal auditors through their Institute may be expected to contribute even further to the confidence with which American business reports are viewed.

29/ Most of the Commission's activity in this respect is accomplished by its staff through informal opinions. Among the rare formal opinions since the widely publicized McKesson & Robbins case are Accounting Series Releases 64 (1948) and 67 (1949) dealing with a registrant and its certifying accountants. An important feature of the opinions concerned the failure of internal control methods with respect to accounting for production costs and residual inventories. Briefly, although the registrant maintained cost accounting and separate production control departments as a result of which fully completed production orders were transferred from finished goods inventory to cost of sales, there was no procedure in effect providing for such a transfer, beginning at the work in process level, for partial shipments. As a consequence, in financial statements filed with the Commission there was a very material overstatement of inventories and corresponding error in costs and profits. Under these circumstances and since the independent public accountants not only failed to take adequate review measures which would have disclosed such an obvious failure of internal control but also failed to observe generally accepted procedures as to physical verification of inventories, appropriate action by the Commission with respect to both the registrant and the certifying accountants was necessary.